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BOOK REVIEWS

Principles of Accounting Advanced

By H. A. Finney and Herbert E. Miller. Prentice-Hall, Inc., New York, N. Y., 1952. Pages: xii + 893; $8.70.

The scope of the fourth edition of this well-known text is probably best indicated by a summary of its table of contents:

Comparison of the above with the thirty chapters of the previous edition reveals the elimination of five chapters on (1) Correction of Statements and Books, (2) Budgets, (3) Public Accounts, (4) Bank Accounting, and (5) Stock Brokerage. With the exception of Budgets, the elimination of these chapters seems well founded on the premise that the areas covered were too specialized. As a personal preference, the reviewer would prefer to have seen the material on budgets expanded, at the expense of the chapters on The Statement of Affairs, Receiver's Accounts, and Realization and Liquidation Reports on the grounds that they too represent highly specialized areas.

Four new chapters have been added. Two expand the previous material on Partnerships. Two provide mathematical background and accounting applications in the area of compound interest and annuities.

Those who are familiar with the previous edition will be pleased to find in the fourth edition the same basic format with liberal illustrations, the same excellence in the treatment of consolidations, modernization to reflect current accounting concepts, and general improvement. In short, this edition is a worthy succesor in a line of famous books whose reputation alone should be sufficient to preclude review of a current edition.

C. W. Bastable

Columbia University
New York, N. Y.

(Continued on page 6)

BOOK REVIEWS

(Continued from page 4)

Asset Accounting

By William A. Paton and William A. Paton, Jr. The Macmillan Company, New York, N. Y., 1952. Pages: xvii+549; $5.00.

This book takes a different approach to the teaching of intermediate accounting in that it is limited to a discussion of the assets of an enterprise. It is designed to avoid the hit-and-miss bundling together of assorted topics usually found under the nondescript headings "intermediate accounting" and "advanced accounting." The book draws together and discusses systematically the accounting problems and procedures particularly associated with business assets.

It is an expansion of the elementary text but written more systematically. It does not overwhelm the student or the instructor with the many principles presented in the handbook style of the first volume. It presents the assets in a logical balance sheet flow. The discussion of each asset includes a comprehensive consideration of cost and value and highlights the relationship of the asset to the determination of net earnings.

In addition to a more or less staple treatment of cash, receivables, inventories, investments, plant, depreciation and intangibles the book covers many special topics of interest to the student and even the practitioner. The study of inventories includes a discussion of the last-in, first-out method and its effect on asset valuation and income. It also includes two excellent chapters on the revaluation of inventories and special inventory problems. Here the effect of price declines, "cost or market" valuations, reserves, replacement costs, etc., are described and illustrated. The problems of retail inventories, inventories in extractive lines, farm inventories, inventories in the construction field, inventories of secondhand, damaged stock, joint-cost products and by-products, etc., are discussed.

Under investments the author explains the accounting treatment for short sales, "dividend" shares, stock options, U. S. savings bonds, exchange and conversion of stocks and bonds. Discounted contracts, annuity and insurance contracts and fund accounting are also explained. Considerable attention is given to plant accounting. Following is a sample list of special topics found here: depreciation during construction, utility accounting for plant and depreciation, insurance adjustments, involuntary conversions and amortization of defense facilities. Changing prices and depreciation cost are as the author states "given systematic and straightforward attention, without apology." The final chapter is devoted to the most complex problem—the valuation of the enterprise.

(Continued on page 7)

BOOK REVIEWS

(Continued from page 6)

The author emphasizes throughout the book the points of view of management and the stockholders. The author has succeeded admirably in meeting this objective. The book impresses by its completeness and overall coverage of the assets of the enterprise. However, unless a student has the opportunity to study the underlying principles for liabilities, equities, costs and revenues he will not have accomplished the objective of the author—laying a solid groundwork of understanding of accounting. It is hoped that the author will give the same excellent presentation to these other areas in his next volume and thus complete an excellent course in the "intermediate" area.

FREDERICK E. HORN

New York, N. Y.

Operating Results of Limited Price Variety Chains in 1951. (Bulletin 138—1951)

By E. R. Barlow. DIVISION OF RESEARCH, HARVARD BUSINESS SCHOOL, Boston, Mass. Pages: vi + 33; $2.00.

This is a survey by the Harvard Bureau of Business Research of reports, made by 44 chains reporting for the year 1951. The 44 participating firms operated 6,153 stores, had sales of $2,240,888,000. and are estimated to account for approximately 90% of the sales of all limited price variety chains in the United States.

Tables and Charts are included which show the comparative results of operations for the years 1950 and 1951. In addition, tables are furnished of sales by 11 chains by merchandise lines for the years 1940-1951 and of gross margins, expenses and profits by 14 chains for the years 1929-1951 and by 8 national and 11 regional chains for the years 1937-1951.

The smaller variety chain should profit particularly from the tables furnished in Section II—Yardsticks for Variety Chains: 1951. Herein the operating data, gross margins, expenses and profits are subdivided into all reporting chains, local chains, regional chains and national chains. Percentages are shown for each item as well as median figures and the high and low percentages of one-half of the reported figures. This section also contains a table showing the compensation of store managers by store volume.

LOUIS WINSTEN

New York, N. Y.

(Continued on page 10)

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BOOK REVIEWS

(Continued from page 7)

You, Your Heirs and Your Estate

By George Byron Gordon. Business Reports, Inc., New York, N. Y., 1952. Pages: 104; $7.50.

Subtitled "An Approach to Estate Planning," this book is intended for the layman. Written in clear, concise and direct language, it should serve to emphasize to the business man or investor of means the problems of providing for his dependents, evaluating his estate, minimizing taxes and the need for careful planning.

The author places the initial emphasis on *people*—the dependents and their needs and on training them to achieve maximum benefits from their inheritances. He then considers *property*—valuation, disposition and investment balance. The federal estate and gift taxes are considered at length and tax savings through *inter-vivos* transfers are carefully weighed. Lastly, as might well be expected in view of Mr. Gordon's extensive experience in that field, life insurance is discussed as an economic instrument, as a tax saving investment, and as a means of rounding out the estate plan.

(Continued on page 96)

THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

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What to Do About Section 102

By J. S. SEIDMAN, C.P.A.

FOR those who don't like the numbers racket, I'd better explain what is meant by 102. There is a provision in the law that imposes a penalty by way of an additional tax of 27½ per cent and 38½ per cent on a company's undistributed income. The penalty applies if the company deliberately avoids paying dividends to the stockholders in order to save the stockholders the tax that they would otherwise have to pay personally on these dividends.

That is 102, and it has had companies in a dither. The problem that is posed by the title of this article is what to do about it. My answer is short and simple. I say, "Do nothing," because anything that is *done* in the affirmative sense is likely to be smarty rather than smart.

J. S. SEIDMAN, C.P.A. and attorney, is a member of our Society, the American Institute of Accountants, the N.A.C.A., and the American Accounting Association.

Mr. Seidman is widely known as an author and specialist in the field of taxation, and has held many high places in accounting, legal and governmental circles. He is a partner of Seidman and Seidman.

This paper was presented by him at the Society's Federal Tax Conference held on November 17-18, 1952, at the Manhattan Center, New York, N. Y. It is based upon a paper which originally appeared in the July, 1950, issue of *Taxes—The Tax Magazine,* with whose permission it is published herein.

To me the best approach that a company can take with reference to 102 is to be natural or, as the song goes, "doing what comes naturally." If 102 is inevitable, relax and enjoy it. Any attempt at window-dressing can only hurt rather than help because the tax pivots around the *purpose* of the company, and window-dressing is a superficial cover that is likely to reveal the underlying purpose.

I have said that companies have been in a dither about this penalty. Actually, the penalty is a psychological one, as a test of nerves. Maybe more realistically it is a test of the directors' nerves because it has been held that a director may become personally liable if he is responsible for handling the company's affairs in such a way that the company becomes subject to the penalty. Directors also are concerned because if the penalty does strike, it may have considerable bearing on the continued financial integrity of the company.

In the last analysis I suppose the real case for jitters is the uncertainty of the impact of the penalty, because there is nothing in the law that says how you are to know whether or not you have been committing hara-kiri on the dividend policy. Yet I submit that as a practical matter, and in a realistic sense, there is very little uncertainty about the law or about the penalty because, by and large, we accountants, if not the company itself, can pretty

well smell out the situation where the penalty is likely to strike.

It never has been imposed except where something affirmative has been done or exists that is a give-away of deliberate manipulation to save tax for the stockholders. The conventional clues are those where the company, instead of paying a dividend, has loaned money to the stockholders, or has retired stock, or has put money into situations or investments wholly unrelated to the company's affairs. The point is that, in truth, there is very little occasion or justification to say that the penalty reeks with uncertainty. The company will generally have *done* something that of itself is a warning to start worrying.

Company managements are also concerned about the fact that maybe this penalty is really a matter of whether the government's judgment is to be substituted for the directors' as to the amount of dividends that should be paid. In so far as I am concernd, that, too, is an unjustified fear because there has never been any case, and in my opinion there never will be one, where the penalty is imposed because of an honest, good-faith difference in judgment or even an error of judgment, if, when the error is revealed, the company does something to correct the dividend policy.

Application to Ordinary Business Company

Having started out with the conclusion on what to do about 102—namely, nothing—I think in all fairness I am called upon to prove my case. I will consider the situation from the standpoint of the ordinary business company, dismissing the holding company or the investment company, as they start with two strikes against them and, under the law, are presumed to run afoul of the penalty.

First, let's look at the record in terms of the arithmetic and history of the penalty. The penalty has been on the books in one way or another for almost forty years, and yet the total number of adjudicated cases involving the penalty that have come across the boards in all of these years is about 400. That in itself tells us from a practical standpoint that the impact of the penalty cannot be too extensive.

Of these cases, many involved holding companies, where the defense necessarily starts weak. In the cases that involed the ordinary business company, sixty per cent were won by the company. The threat of penalty was expunged by the courts. The government won only forty per cent of the cases. To put it another way, in the courts, the government asked for penalties of above $150 million and got above $35 million. Thirty-five million dollars for more than 400,000 companies in existence, and over a period of some forty years, I submit, does not make too drastic a basis for fear of the penalty.

Of course, I recognize that the figures I have thus far given involve only the court cases. Those are the situations where the kettle boiled so much that it over-boiled and the courts were asked to intervene. Let us see what the picture is in terms of the administrative side, as distinguished from the judicial phase. There we find that the government's administration of the penalty has been one of patience and fairness. The fact of the matter is that a revenue agent cannot of his own bring about the penalty. His views must be passed upon by a person in the administration who is a specialist on the penalty. There is thus a double —and a very proficient—check.

The result is that over these forty years, taking into consideration even the administrative cases as well as the court cases, the total number of situations in which the question of the penalty has been raised is less than 3,000. In twenty-five per cent of the cases the government said right off the bat, on its own, that it was wrong. In most of the other cases settlements were reached. Taking all the cases together, the government asked for a

little over $300 million. The total penalty paid to date by corporations—whether through the courts or through administrative settlements—is $75 million.

Again I submit that that is mighty small pickings, considering the tremendous amount of blood pressure and discussion that have been raised about the penalty.

Furthermore, as a practical matter, there are many instances where the company and its stockholders are better off paying the penalty rather than declaring dividends. The arithmetic of this is very simple. The *maximum* effect of the penalty, because of some of the peculiarities of computations, is that of an additional income tax on the corporation of eighteen per cent. The company pays an income tax of fifty-two per cent. That makes a maximum total tax of seventy per cent on the company if the penalty is involved. An individual begins to pay a seventy per cent tax rate when his income is $38,000 or more, if he is single. It stands to reason, therefore, that an individual who has more than $38,000 of income is better off letting the company hold on to the money and, if necessary, paying the penalty than he is getting a dividend on which he would have to pay more than seventy per cent to the government. Married couples with aggregate incomes of $76,000 or more are in the same boat.

So much for the arithmetic. Now, let us consider some of the technical aspects. The penalty pivots around one thing and one thing alone. It is imposed upon a "purpose." I emphasize that because the common conception of the penalty is that it is imposed on companies that unreasonably build up their surplus. The unreasonableness of the surplus has nothing to do with it, except in one sense. If there is an unreasonable accumulation of earnings, then there is a presumption that the penalty is to apply. But actually the only thing that counts is whether the company has been deliberately trying to save tax for the stockholders. If there is that purpose, then it does not make any difference how reasonable or unreasonable earnings or surplus accumulation may be, the penalty still applies.

On the other hand, if there isn't that purpose—if the reason for holding on to the earnings or not declaring dividends has nothing to do with the stockholder tax situation—then it doesn't make any difference how unreasonable the accumulation of earnings is, the penalty does not apply.

For example, suppose these are the facts:

The deliberate and only purpose that a company has for not declaring dividends is that the directors are scheming to depress the value of the stock or to freeze out preferred stockholders or to defeat personal creditors of a stockholder. If those are the reasons and the only reasons, so far as I am concerned, the penalty cannot be imposed.

Suppose the directors have nothing to do with the stockholders; they are not stockholders themselves; and they haven't the slightest idea of what the personal income tax status of the stockholders may be. If those are the facts and the only facts, again this penalty cannot apply.

Obviously, under those circumstances it is clear to see that a small company is likely to be more vulnerable to the penalty than a large company because in the large company there can be complete cleavage between the management on the one hand and the stockholders' personal tax affairs on the other. In the small company the two of them are more likely to be interlinked.

What Constitutes "Illicit Purpose"?

Since the purpose is the thing that counts, how do we discover or determine whether the company has been fooling around with dividend policy in order to save tax for its stockholders?

There are many telltales. For example, there is the thin corporation. It is "thin" because its capital is thin—

so thin that the company is emaciated at the very start. For example, a corporation needs $100,000 capital, which is put in in this way: $1,000 for capital and $99,000 for a loan. The plot is that when the company begins to make money, instead of having to declare dividends, the stockholders will take the money out by collecting on the loan. That type of thinking is one of the clues that the government can properly use to evidence a policy on the part of the company to avoid the payment of dividends in order to save the stockholders tax.

The same sort of thing comes up in another way. Let us assume a company started with $100,000 as capital, and now has made another $100,000. It doesn't want to declare dividends, but it does want to put $50,000 in the hands of the stockholders. Instead of declaring a dividend, the company buys up half of its own stock from the stockholder. Here again is a situation that gives the government a foot in the door from which to assert the penalty.

Sometimes a company, in order to do a little window-dressing, will go out of its way unnecessarily to borrow money, or it will buy unnecessary amounts of inventory or construct unnecessary plants or buy up companies unnecessarily. All of this is done with a view to make it appear that there is no liquidity and the company connot declare a dividend. I regard those tactics not only as unavailing but also as egging the government on to the penalty.

Sometimes a company will say that it is holding on to its money because it has plans for the construction of a building or to buy out a competitor or to combat a price war. Those things are all right provided that at some time or other the plans materialize; or if they don't, then it will be recognized that the original reason for holding back the money no longer exists.

I think the most revealing clues of all are in the tax history of the company. Suppose, for example, there is this sort of a background: while income tax rates are low on corporations, the business is incorporated; if there are excess profits taxes, the company dissolves and becomes a partnership; when the excess profits tax laws are removed, the partnership is incorporated. Such seesawing is indicative of the fact that the company is tax-conscious, and while there is nothing wrong in being tax-conscious, there is something wrong, so far as this penalty is concerned, in being conscious about the stockholders' tax situation in all this.

Sometimes little bits, such as these, in the company's history will prove its undoing: A company ordinarily has paid a dividend at the end of the year. A change in the personal tax rates is enacted so that a dividend paid in the next year means a lower tax to the stockholders than if the dividend is paid at the end of the current year, or vice versa. The company accordingly shifts its regular dividend payment date. This signifies a tax-conscious company, operating its tax dividend policy for the benefit of the stockholders; therefore, the penalty is likely to be brought into play.

Constructive Side of Problem

What sort of things will appeal in defeating the application of the penalty? The best reason for a company's holding onto its money is for its own growth—to build itself up so that it can become larger and larger. No company is required to be static. Every company has the right to aspire to growth.

Furthermore, in the process of growth, no company is required to go out and borrow in order to grow. Every company is justified in growing from within its own financial resources. That is particularly true in the case of the small company because the small company does not have access to the financial or capital markets that a large company has.

Defending against the penalty on the ground that the money is needed for financial growth is the best possible defense. However, there is a limit to

which that argument can be pulled. How do we measure the amount that can be retained for growth? For that purpose, I believe that deviation is necessary from normal accounting concepts. In accounting we know that cash, accounts receivable and merchandise inventory are considered as current assets. For the purpose of determining how much a company needs for growth, it is my opinion that the conception of those items as current assets has a basic fallacy. Every company in order to operate has to have a certain amount of cash; it has to have a certain amount of receivables; and it must have a certain amount of inventory. Without those three factors it cannot do business. To that extent those assets are fixed assets, not current.

Therefore, in determining the liquidity of a company for the purpose of the penalty, the only justified comparison is the *excess* cash, the *excess* receivables, the *excess* inventory in relation to all of the liabilities of the company. Perhaps another way of approaching it would be to compare the cash and receivables with the total amount of liabilities, since liabilities cannot be paid in inventory. Another avenue of approach is to determine the total amount of operating expenses of the company—the fixed irreducible amount that the company must pay to keep its doors open, good business or bad. It has already been held by the Tax Court that a company is justified in retaining a surplus equal to at least one year's operating expenses, and maybe more.

Approached in that practical way clearance from the penalty results in most cases. That may explain the favorable arithmetic of the history of 102.

Suppose when we get all through, the company seems to be in some danger of the penalty. What can be done about it? There are several things. The company can become charitable with its funds and in that way defeat the penalty. The reason for this is that while a company for income tax purposes is permitted to deduct only five per cent of its income for charity purposes, in computing the penalty, charity payments are fully deductible regardless of amount.

Perhaps the most effective way of running away from the penalty is for the company to liquidate. A distribution in liquidation is regarded for the purposes of the penalty as a dividend. The penalty is on the undistributed income. Anything that is distributed, whether it be by way of regular dividends or liquidating dividends, reduces the amount that is subject to the penalty.

If a company liquidates, it must be a real liquidation. Liquidating the company today and starting up a new company tomorrow is not a liquidation. It is just plain camouflage and will be ignored. Also, the liquidation will alleviate the impact of the penalty only for the year in which the liquidation takes place. Earnings that accumulated in previous years, the retention of which could not then be justified, would still be subject to the penalty for those years.

Let us summarize where we stand on the problem of the penalty. In the first place, if anything that I have here written leads into a sense of security that the penalty can be completely ignored, then I have not expressed myself properly. The penalty is on the books and nothing can be ignored that is in the law. At the same time we should recognize that the government can't ignore what the courts have said about the area in which the penalty can be imposed. Also, I hope the government won't ignore the effectiveness and fairness of its past administration of the penalty.

As to the jitters that companies have been experiencing, my advice is: don't be frightened or scared into the declaration of dividends when in good faith there is no occasion for a dividend. Out of an excess of caution we get nowhere.

Finally, I am firmly of the view that no court, and no government official who wants to be fair, will seek to impose the penalty unless the facts are such that the penalty clearly applies.

Problems of New and Collapsible Corporations

By Hugh M. McNeill, C.P.A.

Introduction

In discussing the problems of a new or collapsible corporation, we are assuming that the corporation exists and are confronted with the problem of what to do about it. We are not attempting here to decide whether or not a new corporation should be formed. That is a separate question, so let us assume that we are dealing with the first year of the new corporation and within the early months of that year.

We should satisfy ourselves whether or not the new corporation is a personal holding company, a regulated investment company, or a western hemisphere trade corporation, (which have special problems of their own), or is an ordinary enterprise. Having done so, our first major problem is the choice of a fiscal year. A new corporation has the right to choose any period, not to exceed twelve months, as its first fiscal period and adhere to it thereafter. While it may later change, the unavoidable short period resulting from the change is a "taxable year" for all purposes and may prove detrimental to the corporation's carrybacks, carryovers and other rights and privileges. Should one be so fortunate as to be consulted prior to the formation of the corporation, then a suggestion to defer organization for a short while might be in order. Experience is replete with examples of companies with natural business years being formed shortly before the end of such year, with the result that the all-important first year is a foolishly short period. As will be seen later, if excess profits taxes are still with us, and we hope not, such "year" may materially affect the amount of taxes payable under the applicable ceilings should the company be successful. In any event, the business of the new corporation should be carefully reviewed before selecting the first year-end date so as to have the company's year end with the natural business year and at that date which will present the most realistic statement for financial purposes. Secondly, a determination should be made as to whether or not the corporation is an outgrowth of a predecessor company in such manner that its assets would be valued at the transferor's basis or, stated differently, was the corporation created in a tax-free reorganization. Assuming for the moment that it was so created, then it is possible for the corporation to lose its $25,000 exemption from surtax and its $25,000 minimum excess profits tax credit if securing such credit or exemption was a major purpose of the organization. In this same general area of discussion the company may run afoul of the provisions of Section 129 of the Internal Revenue Code and lose the benefit of a deduction, credit or other allowance to which it otherwise might think itself entitled.

If the corporation is not an outgrowth of a tax-free reorganization, the manner of acquisition of property should be precisely determined in order to satisfy oneself as to the basis of the assets. If the corporation's assets were acquired in a bulk purchase, a determination should be made as to the fair market value of each class of assets in order to make a distribution of the cost thereof by classes. The costs of organization of the company, which are a

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This paper was presented by him at the Society's Federal Tax Conference held on November 17-18, 1952, at the Manhattan Center, New York, N. Y.

non-deductible capital expenditure, must be determined, a basis for valuation of inventory agreed upon, particularly whether or not the last-in, first-out method of inventory valuation is to be adopted, and the method of computing the reserve for bad debts, if any, ascertained. Likewise, other policy decisions will have to be agreed upon, such as the method to be followed in computing depreciation, whether or not the company ultimately might prove vulnerable under Section 102 for surtax on undistributed profits, and the like.

Assuming these general questions have been resolved to the satisfaction of the stockholders, and since excess profits taxes are still with us, let us review for a few moments some of the problems involved in determining the excess profits credit of a new corporation.

The Average Base Period Net Income of the New Corporation

All of you are familiar with the base period rate of return which is proclaimed for 64 industry classifications by the Secretary of the Treasury and which will be found in the official instruction sheets enclosed with schedule EP of Form 1120. A new corporation, that is, a truly new corporation and not a reorganized one, commencing business after the first day of its base period, has the privilege of computing its base period credit by means of the base period rate of return applicable to its industry classification if such credit results in a greater amount than that which it would otherwise receive by means of the invested capital credit or base period income method of computation.

The exact mechanics by which this credit is computed will be found in Section 445 of the Internal Revenue Code. The first step is to determine whether the excess profits tax taxable year is one of the first three taxable years of the taxpayer or is the fourth or subsequent year. If the excess profits tax year is one of the first three years, the credit is determined by applying the industry rate of return to the total assets for the last day of the taxpayer's taxable year immediately preceding its first taxable year subject to excess profits tax plus the net capital addition and minus the net capital reduction for the year. From the product so obtained there must be deducted the interest paid during the year.

If the excess profits taxable year is the fourth or subsequent year then the credit is computed by applying the industry rate of return to the total assets for the same day as that noted above, or the last day of the third year of existence, whichever is later. No net capital addition or reduction is taken into account. From the product obtained there must be deducted the interest paid during the twelve months immediately preceding whichever date is chosen as the basic computation date. Thus, these corporations receive a special benefit in that all of their assets representing borrowed capital are subject to the industry rate of return and are not limited to 75% thereof, although all interest thereon for the year is deducted from the credit.

Now with regard to how many taxable years a taxpayer has been in existence, we are, strangely enough, not dealing here with a legalistic concept of existence but rather a practical concept. The period of time during which a corporation was technically in existence is disregarded for this purpose. We are concerned only with business operation and if a taxpayer was organized as a name holding corporation for many years and that corporation actively engaged in business beginning in 1949, its first taxable year for this purpose would be the year within which it actively engaged in business.

The benefits of this section are inapplicable in those situations where one would logically expect them to be inapplicable, that is, where the corporation took over the assets of another in what might for practical purposes be stated to be a tax-free reorganization. It would be manifestly unfair to permit

an existing corporation to transfer a division to a newly-formed subsidiary and thereby receive the benefits of this section. Accordingly, where the basis of assets is determined by reference to the basis in the hands of the transferor, or where a taxpayer acquired a substantial part of its assets or properties from another corporation and there is at least a 50% stock ownership following through, computed in the usual way, the provisions of this section are inapplicable.

Some misunderstanding has resulted from the requirement that a full year's interest be deducted in computing the excess profits credit under this section. The reason for this deduction is that in computing the industry rates of return, the sum of the net profits and the interest paid during the base period years of each class was divided by the total assets of the industry during those years. In order to achieve a rough degree of equality among new corporations (since there are diverse amounts of borrowed capital), a flat deduction of one year's interest was provided as an equalization measure. Thus the allowed credit is greatest in those cases where equity capital is the financing medium.

The whole purpose of this section is to avoid the necessity of achieving relief to new corporations by means of complicated formulae such as was required by Section 722 of World War II fame.

Excess Profits Tax

A new corporation which commenced business after July 1, 1945, and whose fifth taxable year ends after June 30, 1950, has a "break" in the maximum rate of excess profits tax imposed, in that instead of the current 18% ceiling rate, it is entitled to limit its excess profits taxes at a very much reduced ceiling. If it is the first or second year, the maximum overall ceiling rate is 5%, the third year 8%, the fourth year 11%, and the fifth year 14% limit, except that if the company should be unusually successful and earn more than $300,000, the limitation on the rate is applied only to the first $300,000 of excess profits net income and the current standard 18% rate applied on all amounts in excess thereof. This standard rate was 15% for 1950 and taxable years ending before April 1, 1951, and 17¼% for the calendar year 1951.

In this case, however, unlike the one mentioned before, the technical legal organization of the taxpayer controls the number of its years of existence. The first five years of existence of a new corporation include the period of existence of its predecessors where the corporation is an outgrowth directly or indirectly of another corporation except in certain limited situations. In general, the cases in which the first five years of corporate existence include the period of existence of predecessors, are the following:

1. Where assets are acquired from another corporation in a tax-free exchange;
2. Where a substantial amount of assets is acquired by the new corporation from another corporation, if at least half of the stock of both corporations is owned by the same shareholders (not more than 4);
3. Where a substantial part of the assets of another corporation was distributed by it and acquired by the new corporation, if at least half of the stock of both corporations was owned by the same shareholders;
4. Where the same shareholders control both the new corporation and another engaged in a similar business;
5. Where the new corporation purchases the business of a selling corporation in a taxable acquisition which could be deemed to be a Part IV transaction.

The "tacked on" period of predecessors' existence does not apply where at the beginning of December 1, 1950, the as-

sets so acquired, (or acquired in the ordinary course of business in replacement of such assets) constitute less than 20% of the total assets computed at the adjusted basis for determining gain or loss on sale or exchange. The provisions of the section are inapplicable where more than 50% of the gross income consists of renegotiable business. Extremely complicated provisions are set forth limiting the benefits of the above sections under Part II of the excess profits tax act and a reference to both the law and the regulations should be made before determination of any credit is made if a Part II transaction is present.

Collapsible Corporations

Whether or not it is subject to excess profits tax, all new corporations have the dubious privilege of being considered collapsible corporations. It would be a simple matter if corporations could be sorted into two distinct classes—those which are, potentially at least, collapsible corporations and those which never could be so considered. Unfortunately, though, like most problems in the tax field, the line of demarcation between a collapsible corporation and a sturdy one is, in places vague. Probably the simplest approach would be to determine what might be a collapsible corporation. If a shareholder in a corporation sells or exchanges his stock, or receives a liquidating distribution or a distribution from capital, and upon such transaction realizes gain which could be attributable to the corporation's principal property, then the corporation may be deemed to be a collapsible corporation. The essential element is the property of the corporation which must be stock in trade or inventory upon which the corporation has not realized its full or substantially full profit subject to corporate taxation. Thus, to use the now familiar example, if a corporation is organized to construct a building for sale, and liquidates soon after completion of the building transferring the property to the shareholders, the corporation would most likely be deemed a collapsible corporation and the shareholders subjected to ordinary income tax on the liquidation gain rather than the lesser capital gains tax.

If a corporation has a substantial business history involving production over a period of time upon which due proceeds were realized, and the amount of property involved in the liquidation is small in relation to total production, and the corporation either continues in business or has excellent reasons for quitting, the existence of a collapsible corporation probably will not be raised.

Furthermore, the collapsible corporation rule will not be invoked, if of the total gain of the shareholder from his stock, 70% or less could be reasonably attributable to property manufactured, constructed, produced, or purchased by the corporation.

Two other situations exist where the collapsible feature of the law will not be raised. The first is the liquidation of the corporation within the confines of Section 112(b)(7), a limited situation to be sure, but one with which all are familiar. In that case, only the accumulated surplus, (earnings and profits, to be exact) will be subject to ordinary income tax. The second is most simple. Just have the principal stockholder die and the corporation can be liquidated without difficulty.

One of the major problems of the collapsible corporation is how to determine whether or not the essential ingredient of intent to use the device of such a corporation is present. One can imagine an unusual state of facts where outwardly all of the earmarks of the collapsible corporation are present and yet due proof can be submitted of a complete lack of intent to turn ordinary income into capital gain. The proposed regulations shed some light on how the Commissioner hopes to administer this paragraph of the law. However, extensive criticism has been leveled at the proposed regulations, and it may be some months before the final regula-

tions are promulgated. In the meantime, if one is required to liquidate a corporation, the proposed regulations must be used as a guide to Treasury intent, in spite of their inadequacy. The proposed regulations provide that under Section 117(m)(2)(A), the corporation must be formed or availed of with a view to the sale or exchange of its stock by its shareholders, or a corporate distribution to them of assets, prior to the realization by the corporation of a substantial part of the net income to be derived from its property, which arose from manufacturing, construction, producing, or purchasing, and the realization by the shareholders of gain attributable to such property. The Section may be invoked in any case in which liquidation action was contemplated by those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting stock of the corporation or otherwise. The proposed regulations even provide that the Section will be invoked whether such action was contemplated unconditionally, conditionally, or as a recognized possibility. If the corporation was so formed or availed of for the prohibited purpose, the Treasury's position is that it is immaterial that a particular shareholder was not a shareholder at the time of the manufacture, construction, production, or purchase of the property, or if a shareholder at such time, did not share in such view, and any gain of such shareholder on his stock in the corporation shall be treated in the same manner as gain of a shareholder who did share in such view.

There is an exception to this rule in that any shareholder who holds directly or indirectly 10% or less of the stock of the corporation, realizes capital gain on sale or liquidation of such stock even though the corporation be deemed to be a collapsible corporation. Furthermore, the existence of a bona fide business reason for doing business in the corporate form does not, by itself, negate the fact that the corporation may also have been formed or availed of for purposes of collapse.

Some relief is promised in the proposed regulations in that if the sale, exchange, or distribution is attributable solely to circumstances which arose after the manufacture, construction, production, or purchase (other than circumstances which reasonably could be anticipated at the time of such manufacture, construction, production, or purchase), the corporation shall, in the absence of compelling facts to the contrary, be considered not to have been formed or availed of for purposes of collapse.

Thus, again we have a clearcut case of a law most difficult of administration where one can easily pick out corporations clearly not "collapsible" and those deliberately intended to be so, but these two clear cases are separated by a wide area in which many borderline cases may easily fit with distinguishing guideposts absent because of the lack of judicial determination.

Conclusion

In conclusion, the problems of new corporations are probably best attacked by an approach. All of you are familiar with tax work, and are aware that the principal problem usually is one of where to begin. One suggested approach is to determine the nature of the corporation, then ascertain whether or to what extent it is an outgrowth of a predecessor, what its inherited rights are, what basis it has for its assets and related matters. Next comes a determination of excess profits credit if necessary and finally, if liquidation is contemplated, whether or not the corporation will be deemed to have "collapsed." In this wonderful world of ours it is indeed an anomaly that corporations which are most successful and potentially prosperous shall be deemed to be most susceptible to "collapse." I can imagine some future linguist trying to decipher the lore of our civilization having more trouble with this one than we shall ourselves.

Problems of Relief and Refund Provisions of the Excess Profits Tax Law

By Richard S. Helstein, C.P.A.

Through the introduction of formulae for the determination of qualification and reconstruction under the relief provisions of the Excess Profits section of the Revenue Acts of 1950 and 1951 (Sections 442-447), an attempt was made to avoid the administrative problems which arose under Section 722 of the World War II law.

Under the new Act the problem of construction of a substitute excess profits credit is considerably simplified, and if a taxpayer meets the tests of qualification, it will receive a constructive average base period net income computed under the rules of the applicable section. This did not obtain under the World War II law. There are many cases wherein the Tax Court admitted qualifying events but denied relief because of the unacceptability of the taxpayer's reconstruction.[1]

The arithmetical tests for qualification will effectively eliminate many seekers of relief; but meeting the arithmetical tests will not in itself guarantee qualification for relief. The qualifying event must still be accepted as falling within the intent of the applicable relief section of the law. Because of the similarity of language of several of the relief sections of the excess profits tax imposed under the Revenue Acts of 1950 and 1951 with Section 722 now repealed[2] many of the problems of qualification still remain.

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Section 442—Base Period Abnormalities

Section 442 provides relief if the taxpayer's normal production, output or operation was interrupted or diminished because of the occurrence of unusual and peculiar events in the taxpayer's experience or if the business of the taxpayer was depressed because of temporary economic circumstances unusual in the case of the taxpayer. The language of Section 442 (a)(1) and (2) is almost identical with Section 722 (b)(1) and (2).

Particular emphasis is placed on the fact that the event must be unusual *in the case of the taxpayer*. Thus, if an event were unusual to other members of the taxpayer's industry, but normal for the taxpayer, said taxpayer would not qualify (e.g., a department store located in a city where spring floods were usual would not qualify because of a flood, even though floods would be unusual in its industry).

In addition, the physical event must cause interruption, and the interruption must have an adverse effect on profits. Indirect results may not qualify. For

[1] *General Metalware Co.*, 17 TC —, No. 31; *Danco Co.*, 14 TC 276, (subsequently reconsidered and allowed 17 TC —, No. 185); *Godfrey Food Co.*, 18 TC —, No. 136; *Industrial Supplies, Inc.*, 18 TC —, No. 134; *Powell Hackney Grocery Co.*, 17 TC —, 183.

[2] Compare: Sec. 442(a)(1) and (2) with Sec. 722(b)(1) and (b)(2);
Sec. 443 and 444 with Sec. 722(b)(4);
Sec. 446 with Sec. 722(b)(3).

instance, if as a result of an explosion, certain equipment is destroyed and the use of substitute equipment results in higher labor and material costs, *but there is no interruption of production,* there probably would not be qualification.

One difference in approach in this section may be exemplified in the case of a taxpayer who suffered a strike which curtailed production in one year, but who was able to backlog its orders and fill them in a subsequent year. The Bulletin covering Section 722 of the World War II law denies relief to this taxpayer. Section 442 would apparently grant a substitute average base period net income since it provides only that the income in one year be depressed because of the qualifying event.

If the depressed earnings are due to an economic event under Section 442 (a)(2), the taxpayer must be able to prove that the loss in earnings is directly attributable to the event and not to other factors such as keen competition, higher material costs, etc.

The record of cases tried before the Tax Court under Sections 722 (b)(1) and (2) is both discouraging and puzzling.

Regulations 112, Section 35.722-3 (b) specifies a "price war" as an unusual and peculiar economic event. Yet, in one case[3] a taxpayer claiming relief was a member of an industry which was charged with price fixing by the Federal Trade Commission, *which determined that a price war existed in that industry in 1935 and 1936.* The Tax Court denied qualification nevertheless on the grounds that the low prices were due to keen competition. In fact, "price wars" are pretty well ruled out despite the Regulations, since thus far the Court has held all such conditions to be the result of "keen competition".[4]

In other "economic event" cases, it has been held that legislative acts[5], a record cotton crop[6], government interference[7] and unusual foreign competition[8] are not qualifying factors. The event cannot be due to internal forces such as unaggressive management[9], management decisions[10], or even loss of management due to illness.[11]

Of great importance is the determination of whether the earnings are depressed. The Tax Court has consistently measured the base period earnings against a long-term average of earnings in order to determine qualification.[12] If a long-term average is to be the yardstick of "normal earnings" what years will be included? Pre-World War II years would be fatal in most cases.

Under the provisions of Section 442 (c), which relates to reconstruction where the abnormality affects 12 or less months in the base period, it is necessary to eliminate the twelve months producing the lowest income or greatest deficit. If earnings are seriously affected by the abnormal event, the qualifying year may thus be eliminated and no relief be obtained unless the taxpayer qualifies under the more stringent formulae of Sec. 442 (h).

Another peculiar and unfortunate result may obtain if the qualifying year is the second worst, but the disallowance of an abnormal deduction under Section

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3 *Blaisdell Pencil Co.*, 16 TC 1469.

4 *Monarch Cap Srew & Manufacturing Co.*, 5 TC 1220; *Fish Net & Twine Co.*, 8 TC 96; *Winter Paper Stock Co.*, 14 TC 1312; *Harlan Bourbon & Wine Co.*, 14 TC 97.

5 *Acme Breweries*, 14 TC 118; *Norfolk & Chesapeake Coal Co.*, 18 TC —, No. 116.

6 *Industrial Yarn Corp.*, 16 TC 681.

7 *Trunz, Inc.*, 15 TC 681.

8 *Fish Net & Twine Co., supra.*

9 *Foskett & Bishop*, 16 TC 456.

10 *Phillips Canning Co.*, 17 TC —, No. 147.

11 *The Matheson Co.*, 16 TC 478.

12 *The Wadley Co.*, 17 TC —, No. 30; *The Matheson Co., supra; Industrial Yarn Co., supra; Norfolk & Chesapeake Coal Co., supra.*

433 (b)(9) and (10) raises the net income of the lowest year above the qualifying year. In such a case, it will be necessary to weigh the tax consequences and abandon whichever provision results in less relief.

Section 443—Change in Product

The second of the special relief sections applies to a corporation which, during the last 36 months of its base period, made a substantial change in its products or services. Certain arithmetical tests are set forth for qualification, and these tests must be met within the three years immediately following the year in which the change occurred.

While this section is somewhat similar to the "change in product" provision of Section 722 (b)(4), it is expressly stipulated that the abandonment of a "loss product" which results in an increase in net income is no longer a qualifying factor[13], as it was under the old law.

The Code provides that the change must be "substantial." What is a "substantial" change? A mere improvement or change in style, or ordinary technological development are not qualifying changes. Beyond these simple and obvious limitations lies a field wherein conflicting decisions have made determination dependent upon subjective interpretation and expediency.

In one case [14] a taxpayer changed from the sale of grey yarn to that of colored yarn, which, of necessity, was accompanied by the introduction of a system of color controls, a change in type of customer, and a higher commission. However, the Tax Court held that yarn is yarn and denied qualification.

Although a change in the type of beverage bottled constituted a qualifying change in one case[15], in another the Court reached the conclusion that the change to canned beer was not substantial enough a change from the sale of draught beer[16]. In *General Metalware Co.,* [17] improvements in a product resulting in increased sales were considered merely technological and did not qualify. In *Stonhard Co.,*[18] a manufacturer of building materials introduced three admittedly new products, but the Court decided that the new products did not sufficiently affect the type of customer, markets, or sales policies to qualify.

The Regulations specifically provide that the addition of a new product to a line of varied products will not qualify unless the new product becomes the principal item of sale[19] (e.g., new lines added to a novelty store would not be a "substantial change"). However, this will probably be taken care of by the qualifying requirement under Section 443 (a) (2) which provides that more than 40% of the gross income or 33 1/3% of the net income be attributable to the new product.

The question also arises as to whether a completely new use for an old product would qualify. Probably the innovation of the use of glass in fabrics would be new within the intent of the Statute; but would the use of Television receiver tubes in Radar sets qualify?

Under Section 722 there was no commitment provision for new product, but the Revenue Act of 1951 amended section 443 (f) to provide that if the taxpayer, prior to July 1, 1950, commenced the construction of facilities for the production of the new product, and was committed by contract with another person to obtain a license, franchise or similar right essential for the production of the new product, the time of

[13] Regs. 130, Sec. 40.433-2 (a) (2).

[14] *Industrial Yarn Corp., supra.*

[15] *Seven-Up Fort Worth Company,* 8 TC 52.

[16] *Acme Breweries,* 14 TC 1034.

[17] *General Metalware Co.,* 17 TC —, No. 31.

[18] *Stonhard Co.,* 13 TC 790.

[19] Reg. 130, Sec. 40.433-2(a)(2).

the change to the new product will be considered as having taken place on the last day of the taxpayer's base period.[20]

Section 444—Increase in Capacity for Production or Operation

If during the last 36 months of the taxpayer's base period it doubled its capacity, *or* increased its capacity 50% and had a 50% increase in the *adjusted* basis of its facilities, *or* doubled the *unadjusted* basis of its facilities, it qualifies for relief as having increased its capacity for production or operation.

It might be noted parenthetically that a depreciation adjustment by a revenue agent affecting the last three years of the taxpayer's base period may help the taxpayer meet the second test.

Increase in capacity for production and increase in capacity for operation are in the alternative. The former pertains to physical facilities such as a manufacturer's plants; the latter might cover the type of case such as a sales company which obtained franchises for additional territories. However, in cases where no tangible documents or rights are involved, it may be difficult to demonstrate a doubling of the taxpayer's capacity for operation. How would a personal service company with nominal tangible assets demonstrate a doubling of its capacity for operations?

Another outstanding example of this problem is that of a magazine publisher. Its income stems from advertising which is based on a stated page rate. The page rate in turn is based upon its circulation, and this readership is the product which is sold to the advertiser. Thus, a large increase in circulation, and a concomitant increase in the page rate would result in an increase in capacity for that magazine to earn revenue. Would this be within the purview of Section 444?

A change in capacity must constitute an increase in capacity, not merely utilization of existing capacity.[21] It means the capacity to produce or operate rather than the level of operation actually achieved. A change from one shift to two shifts a day does not constitute an increase but merely the utilization of existing capacity.

Yet even this is controversial. In *Jacobs Fork Pocahontas Coal Company*[22], a mining company acquired new mines during its base period in addition to the mines it already possessed and operated. The Court held, first, that raw material did not constitute an increase in capacity, distinguishing that the statute pertained to an increase in the *facilities for processing* the raw material and, further, that the production from the new mine could have been obtained from the mines already operrated.

There is no formula provided to determine whether the increase in production resulting from the increase in capacity could be sold. It does not appear under the present Excess Profits Tax relief provisions that we shall be faced with the difficult problem of proving that there is sufficient demand to utilize the increased capacity. Lack of such proof was fatal in at least one case under the old general relief provision.[23]

The Revenue Act of 1951 also added a commitment provision to this section[24], but it pertains only to tangible property such as buildings, machinery or equipment. It does not apply to the commitment of a taxpayer to acquire franchises for additional sales territories, or similar rights. Since the commitment rule under Section 443 only applies to the rights for the *production* of a new product, such companies would appear not to be covered.

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20 Section 443(f)(2), I.R.C.

21 Regs. 130, Sec. 40.444-2(a)(1).

22 *Jacobs Fork Pocahontas Coal Co.,* 17 TC —, No. 41.

23 *National Grinding Wheel Company,* 8 TC 1278.

24 Section 444(f)(2), I.R.C.

Section 445—New Corporations

This section applies to a taxpayer which commenced business after the first day of its base period.

This immediately presents the problem of when a corporation "commences business." The Regulations, in an attempt to clarify the issue state: "Ordinarily, a corporation commences business when it starts the business operations for which it was organized; a corporation comes into existence on the date of its incorporation. If the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have commenced business. For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the commencement of business."[25]

This provision follows the decision of the Tax Court in the *Springfield Plywood Corporation case*,[26] where a taxpayer, which was incorporated in 1939 and commenced operations in 1940, was held not entitled to use the "income method" of computing its excess profits credit under Section 713, because it did not commence business until after the end of the World War II base period. Conversely, there is the situation where income producing activities began before the issue of the corporate charter. In such a case,[27] the Fifth Circuit Court held that for the purpose of annualizing excess profits net income, the entire income producing period, both before and after the issuance of the Charter, was to be taken into account.

There is still another facet to the problem of determining when a corportion commences business. Section 461 (d) provides that any corporation which is an acquiring corporation as defined in section 461 (a), is deemed to have commenced business on the earliest date on which its component corporations as defined in 461 (b), commenced business.

Thus, a new corporation created by means of a split-up, a spin-off or any other type of tax free reorganization will not be considered a new corporation if its predecessor commenced business before the first day of the base period.

Relief under Section 445 is not afforded to certain "ineligible corporations".[28] "Ineligible corporations", under Section 445 fall into three main groups: those coming within the tax free exchange provisions of Section 112; those where a new corporation acquires a substantial part of its assets from a transferor corporation and the same individuals own, directly or indirectly, 50% or more of the stock of both corporations; and those where a corporation distributes a substantial part of its business assets on or after December 1, 1950, to its stockholders and a new corporation acquires a substantial part of such properties. (The individuals receiving the distribution must own, directly or indirectly, 50% of the stock of both corporations.)

New corporations, which are "ineligible corporations", may obtain relief under the provisions and limitations of Part II.

Relief for a new corporation under Section 445, as in the other relief sections 442 to 447 is based upon the application of its industry rate of return to its total assets as defined in Section 442 (f), which are valued at the adjusted basis for determining gain. The assets must be held in good faith for the purposes of the business. Thus, if a new corporation were to indulge in large borrowings immediately before the end of its third taxable year, it would be important to be able to demonstrate that such assets were held in good faith for the purposes of the

[25] Regs. 130, Sec. 40.445-1(a)(2).

[26] *Springfield Plywood Corporation,* 18 TC —, No. 2.

[27] *Camp Wolters Land Co.,* (CA-5-1947) 160 F (2d) 84.

[28] Sec. 445(g), I.R.C.

business. While loans which constitute borrowed capital to members of a controlled group are not included in total assets, open accounts with such affiliated companies are not excluded.[29] There may be some question, however, as to whether such open accounts are held in good faith for the purposes of the business.

In computing the total assets for any of the first three years of the corporation's existence, Section 445 (c) provides that the total assets for the last day of the taxpayer's last taxable year immediately preceding its first excess profits tax taxable year be added to the net capital addition for the taxable year in question. If the corporation was formed after the beginning of the excess profits tax years, its total assets for each of the first three years will consist solely in the net capital addition since it had no taxable year immediately preceding its first excess profits tax taxable year.

The question could be raised as to what happens in the case of a taxpayer, incorporated in 1950, that was a personal holding company that year and hence exempt from tax. Its first excess profits tax taxable year is 1951. It appears that the year preceding its first excess profits tax taxable year is its fiscal year beginning in 1950 and the total assets will include the assets held on the last day of that fiscal year.

Section 430 (e) provides additional relief for new corporations. Thereunder, ceiling rates, based on excess profits net income, are set for the first five years of the corporation's existence as follows: first two years-5%, third year-8%, fourth year-11%, and fifth year-14%. It will be noted that the ceiling rates are based on excess profits net income before reduction by the excess profits credit.

Under this section also, "ineligible corporations" are excluded. The tests of ineligibility are the same as under Section 445 (g) except that the date of distribution of assets is July 1, 1945 instead of December 1, 1950. In addition there are some other transactions which will render a corporation ineligible. The most common of these is where a group of four or less persons control a new corporation, who also controlled a corporation which during the preceding twelve months was engaged in the same type of business.

Proposed Regs. 130 Sec. 40.430-2 (e)(5)(ii) provide that the incorporation of a sole proprietorship or partnership under Sec. 112(b)(5) does not result in the transferee taking on the existence of the transferor, but is assumed to have commenced business on the date of its incorporation.

A new corporation which has not established its accounting year will obtain the maximum benefit from Section 430 (e) if it includes a full 12 months in its first fiscal year.

Section 446—Depressed Industry Subgroups

This section presents comparatively few problems. Under the corresponding section of the old law (Section 722 (b) (3)) it was all but impossible to present enough information to qualify. It was necessary to show that the industry to which the taxpayer belonged was subject to a variant profits cycle, that the taxpayer followed the same cycle, and that the taxpayer's earnings were depressed because of the cycle. No corporation has been granted relief by the Court under Section 722 (b)(3), though many have tried.[30]

Section 446 simplifies all this. The depressed industry subgroups are announced by the Secretary. If more than fifty percent of the taxpayer's gross receipts during the base period stem from such industry, it qualifies. If it

[29] Sec. 445(b)(2)(A) refers to Sec. 442(f). Sec. 442(f)(1) refers to Sec. 435(f)(4), which in turn refers to Sec. 439(b)(1).

[30] *El Campo Rice Milling Co.*, 13 TC 775; *Pabst Air Conditioning Corp.*, 14 TC 427; *Foskett & Bishop Co.*, 16 TC 456; *Toledo Stove & Range Co.*, 16 TC 1123; *Roy Campbell Wise & Wright, Inc.*, 15 TC 894.

qualifies, its average base period net income shall be determined by statutory formula. There should be little litigation under this section.

Section 447—Industry Base Period Rates of Return

Section 447 provides that the Secretary shall announce the industry base period rates of return which are to be used in computing average base period net income under the relief sections.

Section 447 (e) provides that in order to obtain relief, application therefore must be filed, and sets forth the rules in connection therewith.

To be timely, the application must be made:

(a) as part of the original return or (b) by filing a claim for refund before the expiration of the Statute of Limitations under Section 322 or (c) no later than the time of filing a petition with the Tax Court in connection with a proposed deficiency. In the last case, the amount of relief afforded will be offset against the deficiency proposed.

Conclusion

The other relief sections dealing with base period abnormalities are applicable to special types of corporations, and were inserted in or added to the Act in order to cover certain specific inequities which were brought to the attention of the legislative committees.

In closing it should be pointed out that one of the most important sections of the Act, and one which may well grant relief in more cases than any other is Section 434 (a) which provides that "the excess profits credit for any taxable year shall be . . . whichever amount results in the lesser tax . . ."

All of the relief sections are geared to this principle and a situation cannot arise where a reduction in tax is not granted because of a comparison of the credit constructed under a relief section with the actual credit.

Section 722 (c) provides relief if the excess profits tax is excessive and discriminatory because the excess profits credit based on invested capital is an inadequate standard for determining excess profits.

Block One Thirty-Nine, Inc.[31] was incorporated in 1941. The invested capital credit taken on its returns was greater than the credit based on constructive average base period net income under Section 722 (c). But the tax under the relief credit was less due to the elimination of the interest adjustment called for when the credit is computed on the invested capital basis. The taxpayer argued that the "effective excess profits credit" under Section 722 resulted in the lesser tax and was therefore to be used, as provided in Section 712. The Court held that there was no provision in the Statute for an "effective excess profits credit", and, adhering literally to the wording of Section 722 (c), denied relief. Doubtless the taxpayer heartily endorsed the sentiments of Mr. Haddock and exclaimed; "If the law says that, sir, the law is an ass."[32]

Under the present law, incidentally, the taxpayer is not confined to the Tax Court. Any claim for relief under the 1950 and 1951 Acts may be processed in the same manner as standard issues.

In enacting the relief provisions of the Excess Profits Tax section of the Revenue Acts of 1950 and 1951, Congress has made every effort to substitute specific statutory requirements for qualification, in the place of "intelligent and sympathetic administration".[33] While there are still problems, many of which may lead to the Courts, the taxpayer's position is much improved. Since the method of computing the substitute credit is prescribed, the taxpayer will know from the beginning how much relief is available, and thus will be enabled to determine whether to sue or not to sue.

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[31] *Block One Thirty-Nine, Inc.,* 17 TC —, No. 164.

[32] *The Uncommon Law,* by A. P. Herbert.

[33] House Report No. 146, 77th Congress, 1st Session to accompany H.R. 3531.

Procedure in Tax Fraud Cases

By Murray L. Rachlin, C.P.A.

Origin of Fraud Cases

Tax fraud[1] can be discovered in many ways. The most common situations are:

(1) The ordinary routine examination of returns by a revenue agent may furnish many leads as to frauds perpetrated by the taxpayer under examination or by other taxpayers with whom he does business. During the course of the agent's review of endorsements on checks he may discover checks cashed at the payor's or payee's banks, checks deposited in savings banks, checks cashed with check cashing agencies, or checks turned over to others by the payee rather than deposited by him. The agent may uncover unrecorded sales, fictitious purchases, padded payrolls and expenses, etc. All or any of these circumstances may lead him to suspect the existence of tax fraud. It is then the practice to refer the case to the Intelligence Unit, and a special agent is assigned to delve into the fraud angle.

(2) Tips for revenge or for reward furnish tens of thousands of leads to the Treasury Department each year. These may come in the form of anonymous or signed letters, telephone calls or even personal visits to any of the department's offices. They come from disgruntled employees, business associates or competitors, from jealous husbands or wives, sweethearts, relatives, neighbors or friends, or from dissatisfied clients, patients, or customers. All of these tips are sifted, screened, and checked within the limits of available manpower.

In many cases these tipsters are interested in the informer's reward. This reward may amount to as much as 10% of the total taxes, penalties and fines collected by the government as a result of the information furnished by the informer.

(3) An agent, during the course of his audit, may uncover evidence causing him to believe that a taxpayer other than the one whose return is under review may have committed a fraud. It is his duty, in such an instance, to notify the Audit Division of the revenue district in which the suspect's place of business or residence is located, furnishing that division with the information which he has uncovered, so that it may proceed, if it sees fit, to start an investigation of that taxpayer's returns.

(4) Banks are required to notify the government of unusual currency transactions of a customer. These notifications are forwarded to the proper revenue districts and are assigned to an agent for investigation, in order to determine whether such transactions were conducted in the form of currency so as to fraudulently evade the payment of proper taxes due on such transactions.

(5) Newspaper articles, investigations by State and Federal investigatory bodies, records of violations of other governmental regulations, and minutes of trials in various courts, often furnish leads to perpetrations of tax frauds. Such leads may be picked up and fol-

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[1] See I.R.C., secs. 145 and 293.

lowed through by an agent or the head of a division acting on his own initiative, or through communications to the Treasury Department by the courts, investigatory groups or other governmental agencies involved.

(6) The Audit Division or the Intelligence Unit will frequently examine the books of check cashing companies, either routinely or as part of a special drive. The information obtained from such records as to checks cashed is diligently followed up to determine whether these transactions were entered into in order to conceal taxable income of the check-cashers.

(7) General investigations of bond purchases, cash purchases of insurance policies and cash real estate transactions very often lead to fraud investigations of the purchasers.

(8) The Revenue Bureau occasionally engages in industry-wide test examinations in order to determine whether fraud has been practised. During the second world war such tests of doctors, dentists, butchers, used-car dealers, dealers in waste products and the like, resulted in uncovering many tax frauds.

Preparation of Fraud Case

In the usual fraud case the investigation is two-pronged. First, a revenue agent makes his examination in order to determine the amount of the tax deficiency. Such an examination is generally rather thorough, including, but not limited to, a complete audit of cash, sales, purchases, payrolls and expenses, with further reference to substantiating records such as vouchers, shipping records, purchase invoices, inventory records, payroll and time records, etc. Such an audit is far more exhaustive, and necessarily so, than the usual revenue agent's examination.

Second, a special agent of the Intelligence Unit conducts his examination with the view to determining whether fraud, either criminal, civil, or both, existed, and if it did, to obtain the necessary evidence indicating such fraud. The special agent works together with the revenue agent on a fraud case, assigning to the revenue agent any items which the special agent wants audited, in addition to those which the revenue agent has audited as part of his own program. The revenue agent also reports the progress of his examination to the special agent from time to time, and informs him of all items which he has uncovered, so that the special agent may decide what course to pursue and what further avenues of investigation to explore.

The special agent conducts his own examination, most often with third parties, going into such matters as bank investigations for supposedly concealed bank accounts, safe deposit boxes, stock brokerage, insurance and real estate transactions, independent circularization of customers and creditors of the taxpayer in order to uncover unrecorded sales and fictitious purchases (in many cases such customers or creditors are actually visited by the special agent), following up of suspicious looking purchase bills by direct visits to creditors to see whether such creditors actually exist, interrogation of employees, business associates, relatives and friends, and generally any collateral line of investigation which the special agent finds necessary to follow up in order to ferret out the existence of fraud.

The special agent also develops net worth statements indicating in complete detail the taxpayer's net worth at the beginning and end of each of the periods under investigation. Increases in net worth are compared with the amounts of income reported on the tax returns filed, giving due allowance in such calculations for taxpayer's living expenses, purchase and sale of capital items, receipts of a non-income nature, and such other items as will help him determine whether such net worth increases are accounted for by reported income or indicate the existence of unreported income. If net worth statements are difficult to de-

velop, the special agent may use the "expenditures" method of determining unreported income. Under this method the special agent works up a record of expenditures by the taxpayer during the period under examination for all items of any nature, comparing the aggregate expended with the income reported, and assuming the excess expended (if any) to be unreported income unless it could be accounted for or satisfactorily explained.

If the special agent feels that a tax fraud has been committed (and it is important to note that there must be a tax deficiency in order that fraud can be alleged) he recommends criminal prosecution in a report which he prepares. Such report is also accompanied by the revenue agent's report indicating the tax deficiency and the reasons therefor. These reports are reviewed in the Intelligence Unit by the special agents' group chief, the Review Division, and the Assistant District Commissioner in Charge of the Intelligence Unit. If they all concur in the recommendation for criminal prosecution, the file is sent to the Enforcement Counsel's Division of the District Counsel's Office. (The District Counsel, under the present Revenue Bureau organization, operates on the same level as the District Commissioner. The District Counsel's Office is a division of the Chief Counsel's Office in Washington, and is subject to supervision from Washington only on matters of over-all national policy and procedure.) At every one of these levels, both in the Intelligence Unit and the Enforcement Counsel's office, the taxpayer is given an opportunity for a hearing, at which he may present evidence or argument against the recommendation of criminal prosecution.

If the Enforcement Counsel's Division concurs in the recommendation for prosecution, the case is sent directly to the Criminal Section of the Tax Division in the Department of Justice in Washington. In the Department of Justice the case is assigned to a senior attorney in the Criminal Section of the Tax Division. This attorney examines the complete file and determines for himself whether criminal charges should be brought against the taxpayer, and whether, if such charges are brought, there is sufficient evidence to insure a conviction. The recommendation of the senior attorney is then forwarded to the Chief Attorney in the Criminal Section of the Tax Division, and from the Chief Attorney to an Assistant to the Assistant Attorney General in Charge of the Tax Division. The case then goes to the Assistant Attorney General in Charge of the Tax Division.

Here too, at every step along the way in the Justice Department, the taxpayer and his attorney are given every opportunity to present any evidence which they possess which may tend to refute the government's charge of criminal tax fraud. It is not uncommon at this stage of the case for a taxpayer and his attorney to convince the Justice Department that the case is not sufficiently strong to warrant prosecution, or insure conviction, and at that particular point the criminal phase of the case may be dropped entirely.

However, if after all this careful review by the Justice Department, the Assistant Attorney General concurs that prosecution take place, the case is sent to the United States Attorney's office in the district where the alleged crime took place, for the filing of an information, where a misdemeanor is involved, or for presentation to a grand jury for indictment, if a felony is involved. It may be possible at this last level for further conferences to take place between the taxpayer, his attorney, and the Assistant United States Attorney who is assigned to the prosecution of the case.

After the criminal charge is disposed of the government may proceed to collect the civil fraud penalty. Steps for the collection of the civil fraud penalty are usually deferred until the criminal charge has been disposed of. The civil fraud penalty is assessed at

50% of the entire deficiency in tax, and not, as some people believe, at 50% of the tax deficiency attributable only to the fraud items. The criminal penalty and the civil penalty are cumulative and not mutually exclusive. Neither a conviction nor an acquittal on a criminal charge will bar the imposition of the civil fraud penalty.

The procedure in the collection of the 50% fraud penalty is generally the same as in the collection of the ordinary tax deficiency. A thirty-day letter is issued, affording the taxpayer an opportunity to file a formal protest. After the filing of such protest a conference is arranged with the Appellate Division. Such conference can concern itself with any of the items of tax deficiency claimed as well as with the fraud penalty. If no agreement is reached, the usual ninety-day letter is sent to the taxpayer, giving him an opportunity to petition the Tax Court for a hearing and trial. If in such a petition the only matter protested is the fraud penalty, then the tax deficiency claimed by the government is immediately assessed.

After the filing of the petition with the Tax Court, a pre-trial conference with government counsel and an Appellate Division representative is afforded the taxpayer for possible settlement of all matters at issue. If no settlement is reached a trial is had before the Tax Court on the tax and fraud issues. With respect to the fraud issue the burden of proof on that matter, and that matter alone, shifts to the government.

If the taxpayer wishes he may let the entire matter go to assessment without trial before the Tax Court, and then file an offer in compromise offering a partial settlement based on financial inability to pay, or a settlement in full payable over a designated period of time. It is important to bear in mind that although the tax deficiency alone bears interest up to this time, after the fraud penalty is finally assessed it, too, bears interest until final payment.

The fraud penalty survives the death of the taxpayer, the Supreme Court having ruled it remedial in nature and reimbursement to the government for expense and loss of revenue. The 25% penalty for failure to file can also be added to the 50% fraud penalty, where warranted. The Commissioner can sometimes assert the 5% negligence penalty rather than the 50% fraud penalty. It is often his practice to suggest the negligence penalty as an alternative before the Tax Court, should the court decide not to uphold his assertion of the fraud penalty. However, it should be noted that the fraud penalty and negligence penalty are mutually exclusive. If the Commissioner fails to include such negligence penalty as an alternative before the Tax Court, it will not be added by the Court nor may it subsequently be assessed.

Books and Records in Fraud Cases

The question of how far a taxpayer should go in cooperating or not cooperating with the Treasury Department in the course of an examination which may result in a charge of fraud is not within the scope of this article. It is a matter which has to be determined in the light of the facts in each case and after considerable thought and discussion between the taxpayer, his attorney, and his accountant. However, some matters in connection with the rights and duties of the taxpayer with respect to his books and records may require comment.

The Fourth Amendment to the Constitution guarantees the right of the people to be secure in their persons, houses, papers and effects, against unreasonable searches and seizures. The Fifth Amendment to the Constitution guarantees that no person shall be compelled, in any criminal case, to be a witness against himself.

It has been therefore generally believed that this constitutional privilege against unlawful search and seizure and against self-incrimination will permit a taxpayer to refuse to turn over any documents or records in his pos-

session, which documents or records may tend to supply information or evidence which will tend to incriminate him in a tax matter in which he is or may be involved. Under such privilege against self-incrimination it is also believed that the taxpayer may refuse to discuss any matter in connection with his tax liability with the investigating agents, refuse to sign any statements, affidavits, or net worth statements and refuse to answer questions either informally or at a formal hearing in the special agent's office. Such a privilege, however, is not available to a corporate taxpayer, and its books and records must be turned over for examination when subpoenaed, even though it may be that information contained in such records might incriminate one or more of the corporation's officers or stockholders.

Records of third parties are not immune from subpoena and are generally requested from the third parties under authority granted by Sections 3614 and 3615 of the Internal Revenue Code. However, such requests made to third parties should be definite in their scope and not in the nature of a fishing expedition.

The privilege against self-incrimination of an individual has been successfully attacked by the government in the *Shapiro*[2] case, dealing with a fruit and produce dealer charged with violation of the regulations under the Emergency Price Control Act of World War II. The majority of the court, in a 5 to 4 division, held that records validly required by law to be kept (in this case by the Emergency Price Control Act to regulate prices) are public records and therefore non-privileged.

While it is generally believed that this particular decision may apply to such public records as those of public agencies and bodies and those required to be kept under special war-time acts, such as the O.P.A., it is not known at this time whether the government intends to carry this doctrine further and contend that income tax records are required public records and as such are not privileged. No attempt has as yet been made by the government, as far as is known, to stretch the doctrine of the *Shapiro* case to income tax records, but the possibility definitely exists and the probability of its use might presumably become stronger in times of national and international stress.

Voluntary Disclosures

Under a policy enunciated by government officials many times since 1934, there existed a practise whereby the Commissioner of Internal Revenue did not recommend criminal prosecution in the case of any taxpayer who made a voluntary disclosure of omission or other misstatement in his tax return, or of failure to make a tax return. A voluntary disclosure was defined as being one which occurred when a taxpayer, of his own free will and accord, and before any investigation was initiated, disclosed fraud upon the government.

Many problems arose in connection with the administrative determination of when a disclosure could be considered to be voluntary. The policy, having no basis either in the Code or in the Regulations, was one where the Treasury Department was the sole arbiter in determining whether a disclosure was timely and whether prosecution should be recommended. Because of this vaguely defined policy considerable confusion and misinterpretation resulted, on the part of taxpayers and Revenue Bureau representatives alike, so much so that in January of 1952, the Treasury Department officially announced that it was abandoning the voluntary disclosure policy because of its "abuse by taxpayers."

Many people feel that such withdrawal of the voluntary disclosure policy was a mistake on the part of the Treasury Department. The Treasury Department itself stated at one time that in a period of eighteen months more than $500,000,000 was paid into

[2] *Shapiro* v. *U. S.*, 335 U. S. 1 (1948).

the Treasury by voluntary disclosures. The government cannot afford to lose so large an amount of revenue.

If the Treasury Department were to recommend that this voluntary disclosure policy be incorporated in the Internal Revenue Code, or were to reinstate it as a policy and buttress it with regulations defining it clearly, it is thought that the Treasury Department would receive many millions of dollars which it ordinarily would not get. It is suggested, therefore, that the voluntary disclosure policy be reinstated and that the following regulations be issued in connection therewith:

1. In order to pin down the date when an examination of the taxpayer has begun, and after which a voluntary disclosure would not be timely, it is suggested that the Bureau of Internal Revenue send a notice of examination or commencement of an investigation by a revenue agent of a particular taxpayer, indicating the year or years under review. Such notice should not be required where a matter is under investigation by the Intelligence Unit.

2. Where a taxpayer has filed no return and no active investigation has been commenced by the Intelligence Unit, or notice of examination by a revenue agent has been sent, a disclosure should be accepted as voluntary.

3. Where a taxpayer has filed a return and no active investigation for that year has commenced, a disclosure should be accepted as voluntary. However, if notice of examination has been received by a taxpayer he should, nevertheless, be permitted to make a voluntary disclosure as to years prior or subsequent to the years in the notice.

4. Where a return has been audited by the Bureau, and after notice of the conclusion of the examination has been sent to the taxpayer, a disclosure as to any transactions or matters not discovered by the Bureau during the examination should be accepted as voluntary.

5. Where the Intelligence Unit has commenced an active investigation of a taxpayer no disclosure should be considered voluntary with respect to any year.

6. Where a taxpayer has been interviewed by a Bureau representative on a matter relating to some other taxpayer, he should still be permitted to make a voluntary disclosure as to any matter not related to the transaction which is the subject of such collateral investigation.

7. The acceptance of a voluntary disclosure should grant immunity from prosecution to the taxpayer and any persons who assisted him in the attempted evasion for the years involved.

Privileged Communications

Communications between a taxpayer and his attorney are privileged, and the attorney may refuse to disclose any information so communicated to him unless the taxpayer (his client) waives the privilege. Such a refusal under the privilege status may extend to answering questions by agents, to interrogation before a grand jury, or during the course of his examination as a witness at a court proceeding. This privilege is broad enough to cover any books and records of the taxpayer which are in the attorney's possession, provided the taxpayer himself could assert such privilege.

The status of privileged communications does not exist as between the taxpayer and his accountant. Because of this, the accountant may be called upon to supply any information he may possess with respect to the taxpayer.

While not all tax cases where fraud is suspected result in the bringing of fraud charges against the taxpayer, it is advisable that the accountant recommend to his client, in matters where prosecution for tax fraud may be indicated, that he consult an attorney, who may advise him of his Constitutional rights and privileges against self-incrimination, the privileged status of communications made to such attorney, and any other matters requiring legal guidance.

Problems in the Sale of a Business

By RALPH G. LEDLEY, C.P.A.

Business Run by a Corporation

When a business run by a corporation is being disposed of, three possible techniques are available: first the sale of the stock of the corporation which, of course, would carry with it the entire business; secondly, a liquidation of the corporation followed by a sale of its assets; and third, a sale of the assets themselves by the corporation, together of course, with the good will of the business.

1. The sale of the stock is from the seller's point of view, by far the simplest and safest method of handling the matter. The seller will have capital gain or loss, as the case may be, which will be long-term or short-term depending on the holding period. The corporation itself will continue operations with no gain or loss since it will have had no transaction. The purchaser, having acquired a corporation presumably on the basis of the value of its assets, can, if he wishes, liquidate the corporation tax-free, or rather without any gain or loss, since he will be receiving something worth exactly what his stock cost him.

Two problems do arise from the seller's point of view. The first is the problem of how to withdraw from the corporation assets which it is not intended to tranfer. These can be purchased from the corporation by the retiring owners or distributed to them in payment of debts or if necessary paid out to them as a dividend, with the usual consequences that result from each such treatment. You must also consider the possibility of the sale of the stock creating income under Sec. 117(m) of the Code, that is the collapsible corporation provision. Since this will be discussed in Mr. McNeil's paper, it is not being covered here.

2. The second possibility for a corporation is a liquidation of the corporation and the sale of the assets by the stockholder. Here we run into the *Court-Cumberland* line of cases. The ultimate fact which may have to be proved is that the sale was made by the stockholders as individuals and not by or on the behalf of the corporation. Thus, the intervention of a trustee acting for the stockholders or the fact that the officers of the corporation conducted the negotiations may tend to prove that the sale was one by the corporation which will, therefore, have to pay a tax on its profits, after which the net assets are distributed to the stockholders in liquidation, the profit being taxed to them at that point. There would seem to be no reason why these sales negotiations cannot be carried on before the corporation is liquidated, but it would be better if this did not occur.

One problem which does arise in this connection is the possibility of a change in value between the date of liquidation and the date of sale. Under normal conditions, if not too much time elapses it may be assumed that the value at

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the time of liquidation and the value at the time of the sale are identical. In at least one case, where the selling price was below the value at the date of liquidation (the sale having taken place about five months after the liquidation) the taxpayer, under the law then applicable, not only got a long-term capital gain on the profit on liquidation but, in addition, a short-term capital loss equal to the difference between the actual selling price and the value at the date of liquidation. Whether this would be allowed by another Revenue Agent in another fact situation is a question, and in most cases no advantage would be gained under the present law unless two fiscal years were involved.

In connection with this *Court-Cumberland* situation a warning is in order about the effect of Sec. 112 (b)(7) which provides for tax-free liquidation during 1951 or 1952 and which section, of course, may possibly be extended to future periods. Like the "flowers that bloom in the Spring", it has nothing to do with the case. The question in 112 (b)(7) is the recognition of gain by a stockholder on the liquidation and the *Court-Cumberland* problem is one of determining whether a sale was made by the corporation or by the stockholders.

3. The third possibility when the business being sold is that of a corporation, is the sale of individual assets by the corporation itself. Here, except in the case of non-depreciable assets, we have individual losses which are ordinary losses and except in the same cases and in the case of depreciable business property or business real estate, we have ordinary gains. In the case of the items excepted, we have capital losses or capital gains. This is an advantageous situation if the net result is a loss or series of losses. These can not only be set off against the earnings of the corporation during the year of the sale but, in addition, may be carried back one year and, if the corporation is put into some other business, the losses can be carried forward for 5 years. In case of gains, the shoe is on the other foot.

Business Run by a Partnership

The sale of a business by a partnership may also occur in the same three fashions, namely, the sale by one or more of the partners of his or their interest, the liquidation of the partnership and the sale of the assets by the partners themselves, and the sale of the business assets by the partnership as such. As to the sale of the partnership interest it has been clearly and definitely held that this is the sale of a non-depreciable capital asset which will result in long-term or short-term capital gain or losses as the case may be. This will be true whether it is a sale by one partner of all of part of his interest or a sale by all of the partners of all or part of their several interests. However, a partner cannot by selling his partnership interest convert ordinary income into capital gain. His share of the earnings for the fiscal year of the sale prior to the date of sale, must be treated as ordinary income.

Upon the liquidation of a partnership no gain or loss occurs, but to the assets withdrawn must be allocated the basis of the partner in his partnership. When the individuals sell the the separate assets which they have received in liquidation, we have a capital or ordinary loss or gain depending on the category into which the individual asset falls. The holding period is a substituted holding period and begins as at the date when the partner acquired his partnership interest, no matter how long or how short a time the partnership itself may have owned the asset in question.

The third possibility in the case of the sale of a business run by a partnership, is the sale by the partnership itself of the business. Here we have exactly the same situation that we had when the corporation sold its business (see above).

Business Run by a Sole Proprietor

Having covered the sale of a business run by a partnership, we now come to the sale of a business run by an individual. Since he already individually owns the assets, any sale by him whether of the business as a whole or of individual assets will be treated as a sale of individual assets and ordinary gains or loss on long-term or short-term capital gain or loss will be determined on each individual item. Sometimes this is an advantage and sometimes it is not. When it is not, the solutions to be considered are the formation of a partnership or a corporation prior to the sale, in which case we have the situation which has already been discussed in connection with the sale of a business run by a corporation or a business run by a partnership. The only special problem that must be worried about is the collapsible corporation provision and for this I again refer you to the paper by Mr. McNeil.

General

In connection with the sale of any of these businesses it is not at all infrequent to find a non-competition agreement on the part of one or more of the principals, which may run indefinitely or may run for a relatively short time. If a proper figure is set the separate cost of this non-competition agreement can be amortized by the purchaser over the life of the agreement (which means that he will like a good heavy cost for it). On the other hand the seller will have to treat as ordinary income the amount which he receives for this non-competition agreement, and if he is on a cash basis and receives it all in a lump, the tax may be almost prohibitive. If, on the other hand, a non-competition agreement is not entered into but good will is sold (or the non-competition agreement is ancillary to and part of the good will), then the good will is a capital asset on which only capital gain (there will rarely be a loss on the sale of good will) will be made, and the purchaser will get no tax benefit until he disposes of it.

Taxation of Deceased Partner's Partnership Interest

By LeRoy A. Kramer, C.P.A.

This paper discusses the treatment for tax purposes of a deceased partner's partnership interest. Legislative enactments have covered but part of the problem. Judicial decisions are attempting to establish a solution to another part, and the author suggests an interpretation of the portion of the problem still unsolved.

The death of a partner creates various tax problems in connection with the disposition of his partnership interest. The method of disposition selected often can determine whether the deceased's partnership interest will pass to his beneficiaries virtually intact, or whether it will be so diminished by income, estate, and estate income taxes that his survivors receive only a mere fragment of this asset.

This asset consists of the partner's interest in his partnership at his date of death, and includes the following four categories:

I His right to his capital account.

II His right to profits earned by the partnership up to his date of death, to the extent not included in category I above, as determined by the partnership's normal accounting method, whether it be on the cash or accrual basis.

III His right to such profits earned by the partnership up to his date of death as are not considered income of the partnership at the date of death, according to the normal method of partnership accounting. This is illustrated by a law partnership on the cash method of accounting, which has work in process for which the partnership has not yet billed the client because it is not completed at the time of death, but which will be income to the partnership when the work has been completed.

IV A possible contractual right to share in the future profits of the partnership.

As to the partner's capital account which exists at the date of death there is no problem. This balance is represented by the deceased's partner's initial partnership contribution plus his earnings during the partnership's duration, less his withdrawals. The income included therein usually has been reported for tax purposes as income, by the partner, when it was earned. This asset must be included for estate tax purposes.

The second category represents his share of the partnership income to his date of death, and is reported for him in his final tax return by his executor or administrator. This amount also is included for estate tax purposes.

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Normally the first and second categories are combined, and the result represents the decedent's partnership account at the time of his death.

The third category represents future partnership income for work presently in process, which normally would not be reported by the partnership until earned. Prior to 1934 such income was merely evaluated for estate tax purposes, and was considered to be corpus. When such income was earned by the partnership, and turned over to the estate, it was applied to corpus valuation. The result was that this income escaped the income tax.

For a better understanding of what is to follow a brief history of Sections 42[1] and 126(a)(1)[2] of the Internal Revenue Code is important. Section 42 of the Revenue Act of 1934 required that all income which was not properly includible by the decedent in his income tax return during his lifetime be accrued and included in his final return. This refers to assets in the third category. This provision was enacted to tax such income, which prior to 1934 was merely included as estate corpus, which when received was applied to the estate corpus valuation.[3]

This provision of the Revenue Act of 1934 required the inclusion of the value of services rendered, whether such compensation was based on a specific amount or on a quantum meruit basis, in the decedent's final return, as compensation.[4] In some instances this resulted in hardship, as the income was superimposed in the decedent's final return, and taxed at extremely high surtax rates.

To prevent this hardship, Section 126(a)(1)[5] was enacted in 1942, permitting the estate to evaluate this income for estate tax purposes as corpus, and to report it as income when received, with a corresponding deduction for the estate taxes paid thereon.

Before the enactment of Sections 42[6] and 126 (a)(1)[7] the courts held that the taxable year of a partnership ended

[1] Revenue Act of 1934, Section 42, 26 U. S. C. A.:

". . . In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period."

Revenue Act of 1942, § 134(a) amended Code § 42 above to read as follows:

Revenue Act of 1942, Section 42(a), 26 U. S. C. A.: ". . . In the case of the death of a taxpayer whose net income is computed upon the basis of the accrual method of accounting, amounts (except amount includible in computing a partner's net income under section 182) accrued only by reason of the death of the taxpayer shall not be included in computing net income for the period in which falls the date of the taxpayer's death."

[2] Revenue Act of 1942, Section 126 (a)(1), 26 U. S. C. A. General Rule.—The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period shall be included in the gross income, for the taxable year when received, of:

(A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

(B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or

(C) the person who acquired from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

[3] Cf. *Nichols* v. *United States,* 64 Ct. Cl. 241, 6 AFTR 6592, 7101 (1927), *cert. denied* 277 U. S. 584 (1928); *Commissioner* v. *United States Trust Co. of N. Y.,* 143 F. 2d 243 (2d Cir. 1944), *cert. denied* 323 U. S. 727 (1944); H. Rep. No. 704, 83d Cong., 2d Sess., §§42, 43 (1934), p. 24; Sen. Rep. No. 558, 73d Cong., 2d Sess., §§42, 43 (1934), p. 28.

[4] *Helvering* v. *Estate of Enright,* 312 U. S. 636, 25 AFTR 1213 (1941); *Pfaff, et al., Executors* v. *Commissioners,* 312 U. S. 646, 25 AFTR 1219 (1941).

[5] *Supra,* note 2.

[6] *Supra,* note 1.

[7] *Supra,* note 2.

with the death of a partner, despite a provision in the partnership agreement to the effect that the death of a partner should not shorten the partnership's normal taxable year.[8] This was on the theory that unless the deceased partner's estate was taxed in his final return for such partnership income, such income would not be taxed at all.

With the enactment of Sections 42[9] and 126(a)(1)[10] the courts reversed their position, by providing that such provisions in partnership agreements would be enforced,[11] since these new provisions taxed this income as of the time when earned, either by the estate or by the beneficiary. This principle is applicable even though under state law dissolution of a partnership occurs when a partner dies,[12] although the partnership is not actually terminated, but continues until partnership affairs are finally wound up.

It is apparent that Section 42[13] was enacted to prevent income earned by the decedent at the date of death from escaping income taxation, and Section 126(a)(1)[14] was enacted to alleviate any hardship caused by Section 42,[15] by enabling the executor or beneficiary to report this income as income when received, and not as accrued as of the date of death.[16] These sections are limited, in their application, to income earned by the decedent at his date of death, and do not include income earned by the estate during the period of administration.[17]

In 1951, in the *Linde* case,[18] the court held that the proceeds of sales of wine, received by the petitioner after the decedent's death, could not be proceeds due to the decedent at his date of death, and hence were not Section 126(a)(1)[19] income, and therefore were not taxable as income of the petitioner. What the petitioner acquired under the decedent's will was an equitable property interest in the grapes, wine, brandy or other products required to make up the unliquidated wine pools, and a right to the decedent's share of the net proceeds of the sales of these products. Since the petitioner acquired these interests by bequest, the proper basis of the determination of any subsequent gain or loss to her on the sale of the products of the pool was the fair market value of these interests at the date of death. As such interests were considered to be capital assets only, the proceeds received by the petitioner in excess of the fair market value of the interests she acquired were taxable to her as capital gains.

While the third category of partnership income, the right to profits for work still in process at the date of the decedent's death, was disposed of by these legislative amendments, the fourth

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[8] *Guaranty Trust Co.* v. *Commissioner of Int. Rev.*, 303 U. S. 493, 20 AFTR 1043 (1938).

[9] *Supra*, note 1.

[10] *Supra*, note 2.

[11] *Girard Trust Co.* v. *United States*, 182 F. 2d 921, 39 AFTR 591 (3d Cir. 1950).

[12] *Supra*, note 11; *Henderson's Estate* v. *Commissioner of Int. Rev.*, 182 F. 2d. 921, 34 AFTR 1343, (5th Cir., 1946); *Mnookin's Estate* v. *Commissioner of Int. Rev.*, 184 F. 2d 89, 39 AFTR 1015 (8th Cir., 1950); *Contra Estate of Isidore Waldman* v. *Comm. of Int. Rev.*, 196 Fed. 2d 83 (2nd Cir., 1952). The Second Circuit makes no attempt to distinguish the decisions of the other circuits. It looks like the United States Supreme Court will have another problem to settle.

[13] *Supra*, note 1.

[14] *Supra*, note 2.

[15] *Supra*, note 1.

[16] H. Rep. No. 2333, 77th Cong., 2d Sess., § 125 (1942), p. 83; Sen. Rep. No. 1631, 77th Cong., 2d Sess., § 135 (1942), p. 100.

[17] *Estate of Ralph R. Huesman* v. *Commissioner of Int. Rev.*, — F. 2d —, — AFTR —, (9th Cir., 1952); *Estate of Edgar O'Daniel* v. *Commissioner of Int. Rev.*, 173 F. 2d 966, 37 AFTR 1249 (2d Cir., 1949).

[18] *Rose J. Linde*, 17 TC 584 (1951), app. by Comm. (9th Cir., March 14, 1952).

[19] *Supra*, note 2.

category of partnership interest, the right to share in partnership profits for a definite period after the decedent's death, has not received the benefit of the same legislative interest. In the absence of legislation the courts have had the burden of establishing rules for the proper treatment of this form of income.

The earliest form of treatment accorded to this right to share in the profits for a definite future period may be termed the "Corpus Theory." Under this approach the right was evaluated for estate tax purposes, and as future earnings were received by the estate they were amortized against the estate corpus value. Only the excess of the profits received over the estate corpus valuations were reportable as income. Needless to say, the Treasury Department did not like this treatment, for no one was paying an income tax upon this income. In the absence of legislative corrective measures, it adopted the approach that such sums as were being paid to the estate represented the cost to the surviving partners of acquiring the deceased partner's partnership interest, and hence held the income taxable to the surviving partners.[20]

In the *McClennen* case,[21] decided in 1935, the articles of a law partnership provided that on the death of a partner his estate should receive, in addition to the decedent's percentage of net profits received by the firm to his date of death, the same percentage of profits received by the firm until eighteen months thereafter, which should be payment in full of the decedent's interest in capital, assets, receivables, and goodwill, all in lieu of a final accounting. The amount paid to the deceased partner's estate for eighteen calendar months after the decedent's death was included by the executor as corpus in determining the estate tax.

The court, in following the early "purchase theory," held that the right to profits was considered as a settlement for the amount which otherwise would be due to the decedent at his date of death. As such, clearly it now would be considered to be Section 126(a)(1) income, being in effect a payment for past services rendered under our present tax laws, but under the laws in effect at the time of the decedent's death its proper tax treatment was uncertain. In fact the Court of Appeals said as much in its decision:

> "In this case we do not have to consider any questions involving the income taxes payable by Mr. Nutter's estate or by his residuary legatee or by the surviving partners in respect to the profit made by the firm during the 18 month period after the decedent's death.
>
> We intimate no opinion as to the many perplexing problems lurking in the background."[22]

While the courts were applying the "purchase theory" to this case, in the same year another apparently equitable approach was developed in the *Bull* case.[23] There the United States Supreme Court held the income taxable to the estate, and not to the surviving partners as under the purchase theory.

The facts of the *Bull* case were as follows: Archibald H. Bull died on February 13, 1920. He had been a member of a partnership engaged in the business of shipbrokerage. The articles of copartnership provided that, upon the death of a partner, the decedent partner's estate was to have the option of continuing the business for a period of one year. His executors so elected. They reported the decedent's share of partnership profits to his date of death in the decedent's last income

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[20] *Hill* v. *Commissioner of Int. Rev.,* 38 F. 2d 165, 8 AFTR 10152 (1st Cir., 1930); *Pope* v. *Commissioner of Int. Rev.,* 39 F. 2d 420, 8 AFTR 10523 (1st Cir., 1930); *McClennen et al.* v. *Commissioner of Int. Rev.,* 131 F. 2d 165, 30 AFTR 238 (1st Cir., 1942).

[21] *Supra,* note 20.

[22] See Rabkin and Johnson, *The Partnership Under the Federal Tax Laws,* 55 Harv. Law Rev. 909 (1942).

[23] *Bull* v. *United States,* 295 U. S. 247, 15 AFTR 1069 (1935).

tax return, and as corpus for estate tax purposes. The right to profits was evaluated for estate tax purposes at $212,718.79, an amount equal to the amount of the profits for the period from the decedent's death to the end of 1920. When the profits were received by the estate they were amortized against cost, and were not reported as income. The Supreme Court stated that:

> "Because of the novelty and importance of the question presented we granted certiorari.
>
> We concur in the view of the Court of Claims that the amount received from the partnership as profits earned prior to Bull's death was income earned by him in his lifetime and taxable to him as such; and that it was also corpus of his estate and as such to be included in his gross estate for computation of estate tax. We also agree that the sums paid his estate as profits earned after his death were not corpus, but income received by his executor and to be reckoned in computing income tax for the years 1920 and 1921. Where the effect of a contract is that the deceased partner's estate shall leave his interest in the business and the surviving partners shall acquire it by payments to the estate, the transaction is a sale, and payments made to the estate are for the account of the survivors. It results that the surviving partners are taxable upon firm profits and the estate is not.[24] Here, however, the survivors have purchased nothing belonging to the decedent, who had made no investment in the business and owned no tangible property connected with it. The portion of the profits paid his estate was, therefore, income and not corpus; and this is so whether we consider the executor a member of the old firm for the remainder of the year, or hold that the estate become a partner in a new association formed upon the decedent's demise."

The *McClennen* case[25] is distinguishable from the *Bull* case,[26] on two grounds. First, in the *McClennen* case the court held that the partnership did have valuable assets which the surviving partners acquired by agreement, while in the *Bull* case there was neither a capital interest nor tangible property owned by the deceased. Second, the facts of the *McClennen* case indicate a sale of the deceased partner's interest to the surviving partners, while in the *Bull* case the court found no such facts.

In the *Boyd C. Taylor* case[27] the court followed the *Bull* case,[28] ruling that an option held by an estate, to participate as a partner in the deceased's partnership for a period of 10 years, was not capital, and hence the estate tax value of this right could not be depreciated by the estate.

In a very strong dissenting opinion, Judge Kern mentioned the fact that prior to the *Bull* case there would have been little doubt that the right to participate in profits for a period of ten years would be capital, and only that part of the partnership income received by the estate which was in excess of the value of the contractual right or chose in action constituting part of the decedent's estate would be subject to income tax.[29]

Judge Kern believed that the *Bull* case[30] should be limited to its own peculiar facts, which hold that if the partnership itself has no capital investments and no tangible assets the contractual right to share in its earnings after the death of a partner cannot be considered to be capital, and cannot be included at any value in the deceased partner's gross estate. The *Bull* case rule has been construed by the Tax Court as not applying to situations

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24 *Supra,* note 20.

25 *Supra,* note 20.

26 *Supra,* note 23.

27 *Estate of Boyd C. Taylor* v. *Commissioner of Int. Rev.,* 17 T. C. 627 (1951), appeal by taxpayer (6th Cir., January 9, 1952).

28 *Supra,* note 23.

29 *William P. Blodget* v. *Commissioner of Int. Rev.,* 13 BTA 1243 (1928), Acq. by Comm'r, 18 BTA 1050 VIII-1 CB 5 (1930); *John F. Degener, Jr.* v. *Commissioner of Int. Rev.,* 26 BTA 185 (1932); *Graham Wood* v. *Commissioner of Int. Rev.,* 26 BTA 533 (1932).

30 *Supra,* note 23.

where the partnership had any tangible assets.[31]

Judge Kern reasoned, in the *Taylor* case, that the inference is that some capital and tangible assets existed. The parties themselves considered the *Bull* case as not applicable, in that the value of the option was included in the decedent's gross estate for estate tax purposes, at a figure of $140,000. Judge Kern said:

> "I am loath to conclude that this right which was valued at this amount for estate tax purposes did not constitute 'a capital asset which it received from the decedent,' and am unwilling to agree that we are forced to this conclusion by the Bull case."[32]

A case seemingly similar to the *Bull* case[33] is the *Bellinger* case.[34] There the deceased had retired from a law partnership, and was to receive the same share of profits that he had received as a partner, for a period of two years. Then he died within the two year period. From the surrounding facts, and the language of the partnership agreement, the court concluded that this share of profits was a "proportion of the profits of the partnership." It rejected the petitioners' contention, based upon the *McClennen* case,[35] that the surviving partners purchased the deceased's partnership interest, as here there was no purchase of assets, because there were none to be purchased. The court said that the language of the *Bull* case[36] was applicable, because

> ". . . the survivors have purchased nothing belonging to the decedent, who had made no investment in the business and owned no tangible property connected with it. The portion of the profits paid the estate was, therefore, income and not corpus. . . ."

Without discussing the fact, the court, by its conclusions in holding the percentage of profits received to be in satisfaction of the deceased's share in uncompleted business, made such profits Section 126(a)(1)[37] income.

There is another group of cases which introduce an entirely different concept concerning the treatment of this right to share in partnership earnings for a stated period after the death of the decedent. They arose where the provisions of the partnership agreement and the intention of the parties indicated that the payments to the estate of its share of partnership earnings were neither payments for the purchase of the deceased's partnership interest nor a share of profits to a bona fide partner, because the estate was not considered to be either of these.

The exclusion of a percentage of partnership profits as the sum to be paid to the estate gave rise to what may be best described as the "creditor theory." In evolving this theory the courts held that the partnership may exclude the payments to the estate by viewing them as a form of self insurance between partners.[38]

This theory was well summed-up by Judge Kern of the Tax Court in the *Coates* case,[39] when he said:

> "In addition to the provisions for the return of the 'capital interests' to the estate are the provisions with which we are here concerned for participation by the estate of a deceased partner in the earnings of the partnership for five years after the partner's death. These payments have no relation to the other type of payments provided for the liquidation of the capital account. They provide simply that the estate of any deceased partner shall participate to the

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31 *Estate of Thomas F. Remington* v. *Commissioner of Int. Rev.*, 9 T. C. 99 (1948); *Charles F. Coates* v. *Commissioner of Int. Rev.*, 7 T. C. 125 (1946).

32 *Supra,* note 23.

33 *Supra,* note 23.

34 *Estate of Frederick C. Bellinger* v. *Commissioner of Int. Rev.*, Docket No. 4562, 46 TCM 83 (1946).

35 *Supra,* note 20.

36 *Supra,* note 23.

37 *Supra,* note 2.

38 *Sidney Hess* v. *Commissioner of Int. Rev.*, 12 T. C. 773 (1949); Acq. by Comm'r, 1949 2 C. B. 2.

39 *Supra,* note 29.

extent there provided in the net earnings of the partnership for a period of five years. The evidence establishes that this provision was intended by the parties not to be the consideration paid by the surviving partners for a capital interest of a deceased partner upon the dissolution and liquidation of the partnership, but was intended to be a present consideration given by each partner upon the formation of the partnership. *It was intended to be in the nature of a mutual insurance plan,* the disadvantage of which each partner was willing to accept in consideration of a similar commitment for his benefit on the part of all other partners, and, in part, as further compensation for the past services of the deceased partner payable after his death."

The line of reasoning here adopted by Judge Kern would seem to indicate that such a right to future profits, insofar as it may be considered to be for past services rendered by the deceased partner, is to be considered Section 126(a)(1)[40] income. If so, as it has been considered as a chose in action, it would be evaluated for estate tax purposes, and reported as income when received, with a corresponding deduction by the estate for the estate tax paid on such income.

The confusion which exists with regard to the estate's treatment of the moneys it receives under the "creditor or insurance theory" is illustrated by following the *Coates* case[41] to its ultimate conclusion. Jacob Rabkin,[42] one of the petitioner's attorneys in the *Coates* case,[43] stated that the right to receive profits was considered to be an asset of the estate, and that an estate tax was paid on it. As the result of the income tax case the estate also paid an income tax on those earnings. The testimony itself is illuminating:

MR. RABKIN: "We took the position that the *Bull* case[44] is sound law today. This is what we did: We filed claims for refund for the estate tax on the ground that we should not have included the right to receive income in the estate tax return. At the same time, contrary to my partner's position in the case, I took the position that Section 113(a)(5)[45] gave us a stepped-up basis of the right to receive that income.

"Let us assume that the right to receive that income was valued at $100,000, and that we included $100,000 in the estate tax return. We had a right to receive that income over a five-year period. I say Section 113(a)(5)[46] gives you a basis of $100,000. We had a right to amortize that at twenty per cent a year. So that each year, as we received the income from the firm, as the estate received the income from the firm, we had a deduction of $20,000. We started an action in the District Court on that refund claim. So we had both these suits going—a suit for the recovery of the estate tax, and a suit for the recovery of the income tax.

"My partner was anxious about the refund of the estate tax; I was anxious about the refund of the income tax; both of us hoping we would win. The answer was that he got there first. The government made an offer to us to refund the estate tax on the ground of the *Bull* case,[47] and that was the solution we accepted. This is a very recent disposition, made last year or early this year.

"I believe that is the present status of the law, Mr. Ekman, or do you not think so?"

MR. EKMAN: "My answer goes back to *Burnet* v. *Sanford & Brooks,*[48] and I think that I am on sound legal ground when I say that there is nothing inconsistent and there is certainly nothing unconstitutional in levying both taxes on the same amount of money."

Thus we see the development of four separate theories concerning the proper treatment of the right of a deceased

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40 *Supra,* note 2.

41 *Supra,* note 31.

42 New York University Ninth Annual Institution on Federal Taxation, Symposium on the Tax Problems of Partnership, pp. 762, 763.

43 *Supra,* note 31.

44 *Supra,* note 23.

45 Revenue Act of 1942, § 113(a)(5), 26 U. S. C. A.:

PROPERTY TRANSMITTED AT DEATH—If the property was acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, the basis shall be the fair market value of such property at the time of such acquisition. . . .

46 *Supra,* note 45.

47 *Supra,* note 23.

48 *Burnet* v. *Sandford & Brooks,* 282 U. S. 359, 9 AFTR 603, X-1 CB 363 (1931).

partner's estate to share in the income of his former partnership for a stated period of time after his death. Clearly, it is most important that both the facts and the partnership agreement clearly indicate which theory the partners wish to adopt. The tax consequences are markedly different in each approach, and are pointed out in the following summary.

Summary

The tax consequences of the first three types of a deceased partner's interest in his patrnership already have been discussed. They may be summed up as follows:

I—The Partner's Capital Account

As the income element of this item has been reported by the partner when earned, during the partner's lifetime, this asset need be included only for estate tax purposes.

II—The Partner's Share of Partnership Profits to the Date of Death

The deceased partner's share of partnership earnings to the date of death will be reported for him in his last tax return by the executor. The net amount remaining after the payment of taxes then will be included for estate tax purposes.

Should the partnership agreement provide that the death of a partner will not shorten the partnership's normal accounting period, then such income, since it is considered to be Section 126(a)(1)[49] income, may be reported by the estate for estate income tax purposes at the end of the partnership's normal accounting period, at the same time taking a deduction for estate taxes previously paid on this income.

III—The Partner's Share of Future Partnership Profits for Work in Process at His Date of Death Which Will Not Be Considered Partnership Income Until Such Work Has Been Completed

Here again we have what is considered to be Section 126 income, having been "earned" by the partner during his lifetime. Hence it is included for estate tax purposes. Such income will be reported for estate income tax purposes, with a corresponding deduction for estate taxes paid on such amount, only when it is reported by the partnership.

It is clear that no major, insurmountable problem exists today with regard to the tax effect of the first three categories of the deceased partner's partnership interest. The difficulty arises in the treatment for tax purposes of the fourth category.

IV—The Partner's Right to a Share of the Partnership's Profits for a Stated Period After His Death

Before the enactment of Sections 42 and 126, such a right merely would have been evaluated for estate tax purposes, and as the income was earned it would have been applied to the estate tax valuation. Hence no income tax would be paid on this partnership income.

Congress, by the enactment of Sections 42[50] and 126(a)(1)[51] of the Internal Revenue Code has succeeded in taxing this income to the recipient, the estate or beneficiary, insofar as the partner's intent and the factual situation indicate that this income represents compensation for past services rendered.

In the absence of clear intent on the part of the partners, and in the absence of facts tending to indicate that such payments were made in recognition of past services rendered by the deceased partner, the courts must determine the disposition of this right to future profits if a contest arises. There is a great deal of confusion with regard to this right, as the law is by no means settled. The most that can safely be said is that the courts will try, on the basis of the facts presented, to classify this right into one of *three sub-categories.* These subcategories are based on the following, alternative interpretations:

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[49] *Supra,* note 2.
[50] *Supra,* note 1.
[51] *Supra,* note 2.

First, that the partnership continues, with the estate taking the place of the deceased partner. On this basis the right would not be evaluated for estate tax purposes. The estate would report its share of the partnership profits as income in the same manner as the deceased would have done had he lived.

Second, and usually the most disastrous to the surviving partners, but most favorable to the estate, is the view that the surviving partners are considered to be purchasers of the deceased partner's interest in the partnership. Under this method the estate pays the minimum tax possible, as the right is evaluated merely for estate tax purposes. As the "income" of the partnership is received by the estate it is applied to the estate tax valuation. This is analogous to the rules in effect prior to the enactment of Sections 42 [52] and 126(a)(1).[53] The total partnership income is considered to be earned by the surviving partners, and hence is taxable to them. The effect is to tax the deceased partner's share of income to the surviving partners. It becomes the obligation of the surviving partners to pay, to the deceased partner's estate or beneficiary, the deceased partner's share of partnership income in accordance with the partnership agreement, undiminished by any income taxes which the partners may have paid on this income. For example: Two partners formerly shared profits equally, and the partnership agreement provided that the estate of a deceased partner was to receive fifty per cent of the profits for a period of two years. The partnership earned $100,000.00 in 1952. The surviving partner reports all of the income in his 1952 return and, assuming that he is married, pays approximately $56,000.00 in income tax. There remains but $44,000.00 to be paid to the estate. Hence the partner has worked, in effect, for a full year without compensation, and in addition must pay to the estate $6,000.00 from his own funds to make up the total amount payable to the deceased partner's estate of $50,000.00. Thus it readily is seen that, because of the high tax rates, the amount payable to the deceased partner's estate becomes a great burden upon the financial position of the surviving partners.

The next situation arises when the estate is not viewed as a partner in the partnership, nor the surviving partners as purchasers of the deceased partner's partnership interest. The tax treatment under this view often results in the payment of the smallest amount of taxes. The treatment of this amount may be considered as compensation for past services rendered by the deceased partner, as previously discussed. This still leaves the problem of the tax treatment of that portion of income which is not considered to be recognition for past services.

Insofar as the surviving partners are concerned, the courts have decided that the amounts payable to the deceased partner's estate are excluded from the partnership income, as being a form of insurance payable to the deceased partner's estate.

Since no cases were found involving such treatment by the estate of such income, this aspect still appears to be unsettled, as was suggested by the *Coates* case.[54]

While it is apparent that there still are no pat solutions to several aspects of the problems and tax consequences involved in the treatment of a deceased partner's partnership interest, it is certain that a properly drawn partnership agreement, clearly setting forth the intentions of the partner, with an eye on the principles discussed herein, often will avoid expensive tax litigation.

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52 *Supra,* note 1.
53 *Supra,* note 2.
54 *Supra,* notes 31 and 42.

Auditing Standards and the Extended Procedures—A Re-examination of Some Basic Concepts

By Benjamin Newman, C.P.A.

Certain changes in reporting practices relating to the failure to employ the extended procedures, as presented in the recently published Codification of Statements on Auditing Procedure, serve as the occasion for a re-examination of some basic concepts. The author explores the background and significance of the standard of field work pertaining to the extended procedures and analyzes the problems and dilemmas which result when the confirmation-observation-inspection procedures are not applied.

With the publication of the *Codification of Statements on Auditing Procedure,*[1] a change in *substance*[2] of *Statements On Auditing Procedure* Nos. 1, 3, and 12 was effected, and with this change has come, subtly and no doubt unwittingly, a modification of certain previously established auditing standards of field work and reporting. The fact of change, however, as in all scientific and creative endeavors, can have only salutary effects if it serves as the occasion for a re-examination of the basic concepts surrounding it. Such a re-examination is the purpose of this article.

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Background of the Change

What is this change which has gone largely unnoticed, and how substantial is it? It relates to the "expression of an opinion in the rare situation where inventory observation or confirmation of receivables, though practicable and reasonable, is not carried out, but other procedures are employed which justify the expression of an opinion. . . ."[3] Prior to the *Codification* the rule[4] had been that where it was reasonable and practicable to employ the extended procedures (i. e., confirm receivables and observe the inventory count) and they were not undertaken then, regardless of the degree of satisfaction achieved by other means as to the accuracy of those accounts, the minimum and mandatory report requirment was that an exception be taken in the opinion paragraph of the certificate.

The consequences were, however, quite different in those instances where

[1] A.I.A., *Codification Of Statements On Auditing Procedure,* 1951.

[2] So characterized in the *Codification,* pp. 7-8.

[3] *Codification,* p. 8.

[4] Originally enunciated in *Statement On Auditing Procedure* No. 1 and clarified in *Statements* Nos. 3 and 12.

the extended procedures were not undertaken because it was unreasonable and impracticable to apply them. In that case it was merely necessary to report the omission in the scope of examination paragraph and an unqualified opinion could be rendered, providing of course the auditor had satisfied himself by other methods.[5] Under either of the two circumstances the auditor's failure to satisfy himself by other means would necessitate a disclaimer of opinion, or, if the amounts involved were not material, an exception. The key terms to bear in mind are *reasonable-practicable, unreasonable-impracticable* and *satisfaction by other methods.*

Nature of the Change

The change in substance effected by the *Codification* consisted in universalizing the rule as it applied to those conditions which justify the omission of the extended procedures because their employment would be unreasonable and impracticable. To quote from the *Codification:*

> "In all cases in which generally accepted auditing procedures are not carried out, or generally accepted auditing standards are not applied, unless the items are not material, disclosure is called for in the scope paragraph, together with either a specific qualification or a disclaimer of opinion, depending upon the relative importance of the items affected, in the opinion paragraph; except that in those rare cases in which the independent auditor has been able to satisfy himself by other methods, a disclosure in the scope paragraph is sufficient."[6]

The desirability of developing an informed background for this discussion will serve to justify an additional quotation from the *Codification,* which clarifies the application of the general rule just quoted to the special circumstances relating to the omission of the extended procedures.

> "In all cases in which the extended procedures are not carried out with respect to inventories or receivables at the end of the period or year, and they are a material factor, the independent certified public accountant should disclose, in the general scope section of his report, whether short or long form, the omission of the procedures, regardless of whether or not they are practicable and reasonable and even though he may have satisfied himself by other methods.
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> "In the rare situation in which they are applicable and are not used and other procedures can be employed which will enable him to express an opinion, he should, if the inventories or receivables are material in amount, disclose the omission of the procedures in the general scope paragraph without any qualification in the opinion paragraph with respect to such omission. In deciding upon the 'other procedures' to be employed he must bear in mind that he has the burden of justifying the opinion expressed."[7]

Unqualified Opinion Now Possible

The effect of this new rule is that the omission of the extended procedures, where it was reasonable and practicable to employ them, no longer makes mandatory the taking of an exception. An unqualified opinion is now possible. With respect to the report consequences resulting from a limitation in the application of these extended procedures, no longer is any capricious distinction drawn between the *reasonable-practicable* and the *unreasonable-impracticable.* And indeed the distinction could not have survived much longer. On the basis of the achievement of identical states of auditing satisfaction (attained without undertaking the confirmation of receivables and observation of inventory count), in one case (*reasonable-practicable*) a cloud had been placed on the opinion, while in the other a privileged position had been accorded the auditor and his client. It was just as though, in the former instance, a penalty had been levied in the form of a mandatory exception, a severe spanking administered to the auditor for his willfulness, care-

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[5] For a fuller discussion of the incongruity of the rule and the tendency to depart from it in the direction of the current rule, even prior to the publication of the *Codification,* see *Correspondence* by Benjamin Newman in The Journal of Accountancy, May 1951, pp. 753-756.

[6] *Codification,* pp. 17-18.

[7] *Ibid.,* p. 21.

lessness, or ignorance, while his professional companion (in the *unreasonable-impracticable* circumstance) was indulged and, in fact, rewarded for his effortless identification with fortuitous circumstance. The old rule is now discarded and the Committee merits commendation for recognizing the incongruity.

Alternative Solution Posed

Of course, the resolution of this discriminatory inconsistency could have taken quite another form. Instead of universalizing the *impracticable-unreasonable* phase of the rule, the underprivileged *reasonable-practicable* side of the old doctrine could have been accorded the dominant position. Then, in all instances where the extended procedures had not been undertaken, a mandatory exception would have been required. In view of the unique and almost regal status afforded the extended procedures since *Statement On Auditing Procedure* No. 1, such a requirement would have been more understandable. No matter that the auditor found himself faultlessly enmeshed in the coils of the *unreasonable-impracticable,* that receivables from the U. S. Government could not be confirmed. The omnipotent extended procedures had not been employed. No more need be said. Be thankful that you have saved yourself (and your client) by other means and that an opinion, albeit qualified, is allowed you.

Such a solution to the problem, however, would have taken no cognizance of the reasoning which, no doubt, motivated the departure from the old rule. An unqualified opinion may now be rendered in all cases where the auditor has *satisfied* himself. If a state of satisfaction has been achieved despite the omission of the extended procedures, then *reasonableness* and *unreasonableness* are irrelevant considerations. Confirmation and observation are only additional tools which the auditor operates to open the gate to that euphoric state. If he satisfies himself, even if by other methods, as to the accuracy of the accounts and the financial statements, he has accomplished all that can be expected or desired—the attainment of that end state of internal assurance which all of his auditing labors have been designed to achieve.

A Deëmphasis of the Extended Procedures?

Does this mean that the extended procedures of confirmation and observation-inspection have been deposed from their professional throne after a reign which has endured from 1939? If not a deposal then perhaps a deëmphasis of the *sine qua non* character of the extended procedures has evolved. That the division of evidential matter into two categories, *internal evidence* (developed from the internal accounting records and documents, and made available to the auditor by management), and *external evidence* (independently secured by the auditor and "unsullied" by management's hand, e. g., by confirmation-observation-inspection)[8] has lost its uncompromising sharpness, is suggested by the following conclusion:

> "The singling-out of these procedures for special consideration arose out of the great interest of the public and the profession in inventories and receivables as determinants of financial position and earnings. The relative space given to them herein should not be taken to mean that they are the only important procedures or *even necessarily the most important.*[9] In some cases other auditing procedures may outweigh them in significance."[10]

[8] For an excellent discussion of the relative competence of evidential matter see, A.I.A. Committee on Auditing Procedure, *Tentative Statement Of Auditing Standards,* 1947, pp. 29-35.

[9] Any *emphasis* appearing in quoted material has been supplied by the author of this article.

[10] *Codification,* pp. 21-22.

If the pendulum has not swung completely back to the *Examination Of Financial Statements* days of relatively greater reliance upon internal evidence, at least the evidential conclusiveness of external evidence is being subjected to critical questioning. The effect of this current may be salutary since it will help to overcome the almost mystical confidence which many accounting practitioners have exuded following upon the feelings of impenetrable security which the traditional application of the extended procedures has aroused. Because the "virus . . . of assigning a greater significance to the written accounting records and documents than is warranted"[11] may have already communicated itself to external evidences.

Undue Reliance on External Evidence—Illustrated

Is such a contamination possible? A confirmation form is mailed to a customer by the auditor. The reply, confirming the receivable, is received from the customer at the office of the auditor. At no stage, apparently, has the client's suspect hand interfered with the mechanism. External evidence has been obtained and an unqualified opinion will be rendered. Although the speciousness of over-simplification is recognized, and it is generally understood that this does not constitute a complete examination of receivables, this narration of the confirmation story, abbreviated though it may be, furnishes a subtle clue to the overtones of naive confidence which may be generated in the minds of certain practitioners.

If the state of confidence be scorned then let illustration be cited to demonstrate the misplacement of assurance. A simple and easily contrivable fraud would consist of the recording of fictitious sales and customers' receivables and exercising control over the mailing addresses. The confirmation forms would then be returned to the auditors by the malefactors.[12] A variation of this technique would take the form of collusion with a related party which occupies an address in connection with other (possibly legitimate) business, whereby sales are purportedly made to this party. A confirmation form would be returned by this party with little hesitancy. A further possibility is a case where, for reasons required by the individual circumstance, sales are purportedly made to actual and possibly well-known concerns. The confirmation form may be mailed out in the name of the "customer", but the address as furnished by the client may be one which is under his control. The fact that auditors have frequently been enveloped by the sacred halo of the extended procedures and, as a result, may have assumed a casual attitude with respect to such "details" as checking the customers' addresses, can only facilitate the perpetration of such a scheme.[13]

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[11] Grady, Paul, *Developments In Auditing,* The Journal of Accountancy, April 1945, p. 276.

[12] It may be significant that this possibility has received little consideration in the professional literature concerned with the relative competence of evidential matter. That the S.E.C failed to suggest, in its *Report On Investigation, McKesson & Robbins, Inc.,* the specific counteractant to this thwarting countermove by the wrongdoers is not readily understandable. In that case, it will be recalled, the auditor's confirmations of accounts payable and inventories in the custody of suppliers were thwarted by that very device. The reason for this oversight may be that the chief concern, in the McKesson case, with respect to receivables, was with the fact that a confirmation of the receivables could have disclosed their fictitious character since the mailing addresses of the "customers" were not controlled by the culprits. The lack of control, of course, stemmed from the client's use of names and addresses of actual and unrelated companies.

[13] Although the illustrations have been confined to receivables, the principles and concepts discussed in this article are equally applicable to inventories and, in fact, to all accounts.

Internal Control and the Extended Procedures

The hazards inherent in carrying out the extended procedures with the frame of mind suggested here arise particularly when the auditor has little ground for achieving a state of satisfaction by other methods. Particularly is this so where the system of internal control is so poor as to remove any element of credibility from the conventional internal evidences.[14] It is primarily, however, in those instances where a poor system of internal control prevails that the auditor seizes upon the extended procedures to bolster his shattered program, and accepts their omnipotence with proper and unquestioning subservience. It is in this sense that the deëmphasis of the extended procedures suggested in the *Codification* will have a salutary effect.

How Substantial Is the Change?

Still unanswered is the question initially posed: How substantial is the change wrought by the *Codification?* The treatment of the relevant concepts developed here suggests that a constructive and not illogical resolution of the *reasonable* vs. *unreasonable* conflict in reporting practices has been accomplished together with the achievement of a more mature perspective with respect to the role of the extended procedures. The foundation has not been shaken; rather has it settled somewhat and, certainly, the basic philosophy and standards of auditing, and with them professional practices, have undergone no fundamental change. Such a conclusion, however, on the part of the reader would do little justice to the concepts discussed. The attempt has been made to intimate the issues which arise when sound understanding of the concepts is sought, and to suggest the inconsistencies and dilemmas which must be resolved before a harmonious system can be built. Any easy reassurance which may have developed should rather call for caution and create a challenge to dispel any facile solution to a vexing problem. Because the problem is troublesome indeed and, apart from any consideration of the substantiality of the change, suggests that the entire area of auditing standards and the extended procedures has not completely emerged from the exploratory stage.

With the change in rule set forth in the *Codification,* at the very least, a dilemma has been created. If it is now possible to achieve a state of auditing satisfaction without the employment of the extended procedures, then what is the status of the standard of field work governing the competence of evidential matter? The standard is crystal clear and as with all standards, by virtue of the very definition of a standard, provides for no exception.

> "Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination."[15]

The categorical effect of the very wording of the standard is quite plain. It does not call generally for sufficient competent evidence but rather for a specific type of evidence, namely ex-

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[14] The purpose of an examination of the system of internal control has been, traditionally, to determine the quantitative scope of examination. The equally important if less publicized reasons for such an examination stem from the correspondence which exists between the adequacy of the system and the credibility, reliability and authenticity of the internal evidences and records *actually examined.* It will also determine the *type* of tests necessary to evaluate and substantiate the apparent reliability of the evidences examined. This means, simply, that given a poor system of internal control there is less reason for believing in the authenticity of the documents and records examined, for the reason that greater opportunity existed for tampering with the records and documents. For what is probably the first clear statement of these principles see, S.E.C's. *Report on Investigation, McKesson & Robbins, Inc.,* 1940, pp. 378-379.

[15] A.I.A., *Statement On Auditing Procedure* No. 24, October 1948, p. 165.

ternal evidence.[16] If the possibility of achieving a state of auditing satisfaction by "normal" methods is envisioned by the new *Codification* rule, making possible thereby the expression of an unqualified opinion, then how can this state of affairs be reconciled with the categorical character of the quoted standard? The auditor who, for whatever reason, has not confirmed receivables and/or observed-inspected inventories or other material assets, would then find himself in the position of rendering an unqualified opinion despite the violation of a cardinal standard of auditing.[17]

The Nature of Auditing Standards

Is an opinion possible where a standard of auditing has been violated?[18] The very definition of auditing standards precludes such a possibility.[19] An original and classic definition, inspired by S.E.C. discussions, reads as follows:

> "Auditing standards may be regarded as the underlying principles of auditing which control the nature and extent of the evidence to be obtained by means of auditing procedures."[20]

That procedures and auditing standards, although related, are not synonymous, is clear from the following authoritative statement:

> "Auditing standards may be said to be differentiated from auditing procedures in that the latter relate to acts to be performed, whereas the former deal with measures of the quality of the performance of those acts, and the objectives to be attained in the employment of the procedures undertaken."[21]

Since auditing standards are measures of the quality of performance it is obvious that they have universal and invariable applicability.[22] Therefore any departure from a standard would negative the expression of an opinion. Obviously if the quality of performance (i. e., the standard) has been vitiated, little ground exists for reliance upon the examination and any belief in the fairness of management's representations would be unreasonable. If it is contended that the extended procedures are not necessarily all-im-

[16] It may seem odd that the standards of auditing (as officially promulgated in *Statement* No. 24) contain no reference to the need for acquiring sufficient competent *internal* evidence. Perhaps this need is implied in the following standard of field work: "There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of tests to which auditing procedures are to be restricted." Perhaps the necessity to obtain sufficient internal evidence is so basic a requisite as to be almost axiomatic and therefore requires no expression in a *standard*. Although this "oddity" will be subsequently discussed it may be of interest to note, in this connection, the rule of professional conduct (5d) of the A.I.A.: "In expressing an opinion on representations in financial statements which he has examined, a member may be held guilty of an act discreditable to the profession if he fails to acquire sufficient information to warrant expression of an opinion . . . ."

[17] Running through the exposition in the *Codification* are cautionary notes suggesting the difficulty of achieving satisfaction by methods other than the extended procedures. For example: ". . . except that in those *rare* cases in which the independent auditor has been able to satisfy himself by other methods. . . ." (pp. 17-18) An expression of caution, however, while commendable, only serves to confirm the fact and seriousness of a permissive departure from the standard.

[18] In this connection the reader should review the quotation, supra, from pp. 17-18 of the *Codification* to the effect that "in all cases in which generally accepted auditing procedures are not carried out, or *generally accepted auditing standards* are not applied" an unqualified opinion is permissible if the auditor has otherwise satisfied himself.

[19] It is rather late, historically, to review more thoroughly the basic concepts dealing with the nature of auditing standards. For a satisfactory bibliography of the earlier discussions in the area see A.I.A's. *Contemporary Accounting*, 1945, Chapter 11, pp. 27-28.

[20] A.I.A., *Statement On Auditing Procedure* No. 6, March 1941, p. 46.

[21] A.I.A., *Tentative Statement Of Auditing Standards,* 1947, p. 9.

[22] This is recognized in the noted A.I.A. bulletin, *Audits By Certified Public Accountants,* 1950: "Whereas auditing procedures must be varied to meet the requirements of the particular engagement, standards to be observed in selecting and applying the procedures are the same in all circumstances." (p. 25).

portant[23] and that procedures (if not standards) may be varied to meet the requirements of the particular engagement, the inescapable fact remains that the extended procedures are a specific and integral part of the official standard. Any failure therefore to acquire sufficient evidence by confirmation and observation - inspection automatically constitutes a violation of the standard.

Perhaps, then, a mistake was made originally in the formulation of the standard by the singling-out of the special procedures for exclusive comment. Should the standard have been worded somewhat as follows?

> "Sufficient competent evidential matter is to be obtained to afford a reasonable basis for an opinion regarding the financial statements under examination."

Since a standard of auditing must have pragmatic value and must operate as an objective guide to practice, such a generalized version would so attenuate the standard as to convert it into merely a banal *objective* of auditing.[24] The absence of a mandatory requirement as to the employment of the extended procedures would please the careless and disorientate the sturdy. Opportunity would be afforded for unintelligible variations in auditing practice and therein lies a suggestion of the substantiality of the change effected by the *Codification* and of the gravity of the consequences.

Internal Evidences v. External Evidences

But the feeling persists: Why should the extended procedures be singled out? Are not the internal evidences equally important? Such inquiries are certainly understandable in the light of the pitfalls previously outlined in the illustrated cases of confirmation of receivables in which the security obtained by the mechanics of confirmation was found to be without foundation. If the extended procedures are not any more immune to flaws and machinations than internal evidences, then are they worthy of the honor accorded them?

Such an inquiry, however, would betray forgetfulness of the events which led up to *Statement On Auditing Procedure* No. 1, and of the dangers inherent in exclusive reliance upon the internal evidences. Forgotten would have been the classic phrases:

> ". . . there should be a material advance in the development of auditing procedures whereby the facts disclosed by the records and documents of the firm being examined are to a greater extent checked by the auditor through physical inspection and independent confirmation. The time has long passed, if it ever existed, when the basis of our audit was restricted to the material appearing in the books and records."[25]

It is always assumed that the internal evidences and records will be thoroughly scrutinized and that the relative reliability of the various types of internal evidences will be recognized and evaluated. The professional auditor receives no accolade for super-inquisitiveness on this score. Such an examination has always been and will continue to be a *sine qua non* of auditing. Nor can it represent the essentials of a standard of auditing in the sense of a measure of performance, because without such an examination of internal evidences and records, auditing itself, as a concept, as a function, and as a profession, vanishes. A standard which measures the quality of performance with respect to the degree of discrimination in the selection of evidential matter can start to operate only when the "internal evidence" foundation has been laid. This leaves only external evidences (i. e., the extended procedures) as the exclusive, illustrative components of the standard.

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23 *Codification,* p. 22.

24 An excellent exposition of the nature of a meaningful standard appears in John L. Carey's article, *The Accounting Profession's New Opportunities,* The Journal of Accountancy, October, 1945.

25 *Report on Investigation,* op. cit., p. 445.

Such a dismissal of internal evidences should not be misunderstood. If internal evidences are not privileged to be selected for a role in the standard it is only because they occupy a dominant and precedent position, as previously explained. So important in fact is the role of internal evidences that ineptitude in their examination, intrinsic inadequacies of the internal records and documents, or their lack of internal consistency, will result in a collapse of the audit function which our noble standard, itself, no matter how extensively or conscientiously applied, will be unable to revive. Their examination must therefore be undertaken with the greatest of professional care. In his professional work, the auditor must "employ that degree of vigilance, inquisitiveness, and analysis of the evidence available that is necessary in a professional undertaking."[26]

The Import of the Extended Procedures

Although the standard of *due care*[27] is designed to ensure that the procedural examination of the internal records and documents is professionally, rather than mechanically, applied, a gauge is nevertheless necessary to evaluate the quality of that examination. The extended procedures and the related standard furnish precisely such a gauge, and therein lies the sublimity and necessity of our standard. For the very employment of the observation-inspection-confirmation procedures attests, in particular, to the level of the examination of the conventional evidences and records, and, generally, to the quality of the total examination. Correspondingly, the failure to employ the extended procedures, or procedures which are equivalent to them in terms of their degree of independent and penetrating inquisitiveness, can only represent prima facie proof of the inadequacy of the "internal" examination. The extension of the examination into the emancipated area of independently obtained evidences by direct confirmation-observation-inspection is the conclusive test of the "spirit" with which the examination is conducted. This "spirit" cannot be manifest where the examination is confined to the internal evidences because of the basically suspect nature of those evidences. Such is the meaning of the extended procedures and related standard of field work.

The Importance of Due Care

If this standard is indicative of a spirit of unrelenting inquisitiveness, then it is obvious that the carrying out of the standard via the acquision of external evidences must itself be beyond reproach. "The difference between procedures professionally applied and procedures merely perfunctorily applied"[28] applies here equally as well, and it is this difference which accounts for the failures of the confirmation procedure previously illustrated. Unlike internal evidences, the extended procedures, under normal circumstances, do not possess innate limitations. By their very character, and almost by definition, they reflect the quality of infallibility under most circumstances. The reason for the inefficacy cited, as for example in those cases where the addresses of the purported customers were under the control of the malefactors, is that the extended procedures were not "extended" to their potential limits. Independent inquiry and investigation, itself a form of external evidence, was not undertaken to achieve satisfaction as to the bona fides of the names and addresses submitted.

26 S.E.C., *Accounting Series Release* No. 19, December 1940, p. 34.

27 The standard reads: "Due professional care is to be exercised in the performance of the examination and the preparation of the report." (*Statement On Auditing Procedure* No. 24, p. 165).

28 *Tentative Statement Of Auditing Standards,* op. cit., p. 18.

Extension of Concept of Supplementary Inquiries

The *"due care"* traits, alertness, inquisitiveness and vigilance, have no boundaries. The necessity for their manifestation in undertaking the extended procedures has long been recognized in the case of inventories in public warehouses where, in addition to obtaining confirmation in writing from the custodian, it is expected that supplementary inquiries will be made.[29] The supplementation of confirmation by independent inquiry and investigation to determine the bona fides of banks and security custodians has also been recommended.[30] The need for such supplementary inquiries and investigation, however, with respect to the bona fides of receivables has not received expression in professional literature. Any extension of the principle to receivables, however, must be considered in conjunction with the preparation of sorely needed case studies illustrating the nature of "independent inquiry" and the form which it may take.

Satisfaction by Other Methods

An obvious concern created by this analysis is that the auditor, who has not undertaken the extended procedures because their employment was unreasonable and impracticable, finds himself (and his client) the victim of circumstances beyond his control. Considerable authoritative literature exists, however, to assure him that his situation is not hopeless. He can, as the phrase goes, satisfy himself by other methods. His only problem is the determination of what is mean by "other methods." In the course of his research he will encounter the same frustration which plagued the auditor who may have sought enlightenment on "independent inquiry"—a paucity of practical case material.[31]

In the light of the discussions regarding the meaning of the standard calling for sufficient external evidence it is clear that "other methods" can only mean the acquisition of evidence which is intrinsically the same as confirmation-observation-inspection. This interpretation is in agreement with the following conclusion set forth in *Audits by Certified Public Accountants:*

> "Although confirmation of accounts receivable is generally practicable and reasonable, circumstances occasionally arise under which it is not. The CPA may be able, in some cases, to satisfy himself by other, special auditing procedures which are substantially the equivalent of confirmation in the circumstances."[32]

What Is Meant by Other Methods?

Since internal evidences can never be substantially equivalent to confirmation-observation-inspection, for the underlying reasons given, any attempt to identify the above-mentioned "special auditing procedures" with internal evidences, no matter how apparently reliable the latter may be, would reflect a departure from basic principles. This faulty identification of "other methods" with the conventional accounting records and documents may be illustrated by the following classic discussion relating to the verification of receivables from the U. S. Government where circumstances make their confirmation impracticable:

> "In many, and perhaps most, cases the independent public accountant may be able by reference to shipping records, contracts, correspondence, or other documentary evidence, or the subsequent payment of the accounts, to satisfy himself on a test basis as to the validity of such receivables. In such cases his disclosure of inability to secure confirmation of government receivables by communication with the debtor may well be accompanied by a statement

(Continued on page 66)

[29] A.I.A., *Statement On Auditing Procedure* No. 1, October 1939, p. 7.

[30] *Tentative Statement Of Auditing Standards,* op. cit., p. 30.

[31] The initial, and perhaps the only, attempt to shed some light in this field is the article by P. N. Wehr, *What Are Alternative Procedures, And How Should The Auditor Use Them?,* The Journal of Accountancy, June 1950.

[32] *Audits by Certified Public Accountants,* op. cit., p. 38.

Methods of Funding Pension Plans Involving Less than 50 Lives

By Herbert L. Jamison

An experienced insurance counsellor describes the various ways of funding pension plans for smaller businesses. Both insured and self-insured plans, as well as profit-sharing trusts, are considered in this paper.

Preliminary Steps

The first step for the employer who wants to start charging against each year's earnings the cost of that year's "employee depreciation", is to ascertain, with his accountant's advice, how much can prudently be set aside for that purpose. This may be 5% to 10% of the total payroll or a percentage of the firm's profits. It is advisable to start with an annual amount which can reasonably be expected to be afforded in bad times as well as good.

The fear of many small and medium-sized business concerns that pensions are extremely costly, and can only be afforded by big business, is unfounded. Unfortunately over the past 15 years, and particularly during the period of abnormal profits, a number of very liberal pension plans were started which resulted in grief for employer and employees alike when hard times came and the plans had to be cut back and in some cases discontinued.

It is not generally understood by employers, who fear to commit themselves to a definite pension plan, that funds in good years may be used to keep the plan going during several lean years. Even under Group Annuity Plans, where the past service liability is expected to be funded over ten to fifteen years, the insurance companies permit reducing or waiving several years' past service payments until earnings return to a point where the larger amortization payments can be afforded. Under individual policy pension trusts, provision can also be made for using money from auxiliary or profit-sharing funds, or even borrowing on cash values to pay the minimum premiums required to keep the policies in force during low profit years.

When the amount to be used for a pension plan is determined, a Pension Consultant should be called in to advise on the scope of a plan covering the employer's wishes (a) as to the employees to be included (eligibility) and (b) the minimum pension (with or without social security) to be provided at retirement. Where there are a number of employees over age 60, it may be necessary to exclude them from the formal plan in order to keep within the budget cost. The consultant can set up a retirement formula for these employees on a pay-as-you-go basis, or they may be included under the plan on an age 70, instead of an age 65, retirement basis.

Herbert L. Jamison, the Society's insurance consultant, has practiced in this field since 1920. He is one of the early graduates of the Insurance Institute of America, and has conducted insurance courses and lectured for the Insurance Society of New York. Mr. Jamison has had long, varied and responsible experience in the area of pension planning.

This article is based on a paper presented by Mr. Jamison at the June, 1952, conference of the Society, held at Saranac Inn, N. Y.

Unless group life insurance, providing amounts approximating one year's salary, is already being carried, the plan may include a life insurance death benefit prior to retirement. Because it is unlikely that groups of 50 or less would be carrying group insurance providing any more than a $5,000 maximum, the Individual Policy Pension Trust probably will be the best bet for those desiring the life coverage. With the present high tax rates, executives and key employees find it difficult to carry adequate protection for their families. For this reason death benefits are an important consideration.

Insured Pension Plans

Retirement Income or Ordinary Life policies may be used and the death benefit is usually 100 times the monthly pension at 65. For example, an employee earning $250 a month and eligible for a pension of $100 a month (excluding social security) would be insured for $10,000 or 3⅓ times his annual income. This feature is one important advantage of an insured plan over a self-insured plan. No small, and very few of the largest, employers can afford to go into the life insurance business.

Where a death benefit prior to retirement is not an important consideration, Group Annuities have many advantages. However, the actuarial and administrative detail under such plans is so extensive that most of the large companies will not undertake plans with less than 50 lives. No American company that we know of will underwrite groups of less than 25.

A Deposit Administration type of plan is available to small employers from several insurance companies specializing in Pension Trust business. Instead of using high premium Retirement Income or Deferred Annuity policies, lower cost Ordinary Life policies are used under this plan.

A big advantage of such a plan is that it does not involve as large a definite annual commitment; thus there is less likelihood the plan will have to be dropped during bad times. Under this plan the insurance company furnishes the additional annual reserve which should be set up each year for each eligible employee, to provide a fund which at his age 65 is sufficient, with the cash value in the employee's ordinary life policy, to provide the desired pension. The total amount of these reserves is administered by the insurance company in a separate auxiliary fund on which they *guarantee 2%* compound interest and on which most companies are currently paying 2¾%.

In addition to the fact that this plan saves the employer approximately 6% of his cost compared with the plan using Retirement Income policies, the extra reserve payments may be reduced or omitted in lean years. Provision can also be made to advance out of the auxiliary fund the basic life insurance premiums in extremely bad years. Of course repayment of such premium payments and of the omitted auxiliary reserves should be made in good years so that when employees start to retire there will be enough available to their credit in the auxiliary fund to cover their pensions.

Under this type of plan, particularly if there are no employee contributions, the employees need not have any vested interest in the auxiliary reserve fund, but only in the life insurance cash value. It is also easier for an employee to continue his policy after termination because the Ordinary Life premium is much lower than the Retirement Income premium.

An important advantage of the plan is that each employee's policy contains guaranteed retirement benefits regardless of changes in mortality and interest rates prior to maturity. Also the life policy annuity options are even better than the present-day annuity rates.

For firms which would prefer to handle the auxiliary fund themselves, or wish to appoint a corporate trustee, an actuary should be employed to set

up the fund and recompute it annually. Unless the accumulations in the fund are fairly substantial there would not be much saving (assuming 75% of the fund were invested in government bonds or other legals) if part (say 25%) were invested in common stocks.

Brochures describing the plan finally to be adopted are prepared by the pension consultant in collaboration with the insurance company selected. They are usually distributed not only to the employees immediately eligible, but to all other employees in order to realize the employee-relations benefits of such a plan.

Self-Insured Pension Plans

Conservatively managed companies with a steady past earnings record and good prospects for the future and which are not interested in life insurance benefits prior to retirement, may find that an actuarially-sound self-funded pension plan costs less than an insured plan even where the reserves are invested in 2½% government bonds and including the actuary's and trustee's fees. One reason for the lower cost is the elimination of insurance agent's commissions and some of the insurance company's overhead expense not covered by the difference between 2½% and their 3.2% over-all average earnings.

There is more flexibility under this type of plan than under either group annuity or individual policy plans. Under a self-insured plan the retirement benefits may be based on average earnings for the 10 or 15 years *prior* to retirement. Provision can also be made for total disabilities prior to retirement. Any increases in interest yield on invested reserve funds *reduces* the firm's cost. The mortality (deaths of employees prior to retirement) in excess of the average mortality provided by the insurance company annuity tables also reduces the firm's cost.

The firm's contributions are recovered in *full* at termination of employment as contrasted with deductions for surrender charges under both the group annuity and individual policy plans. It is also easier to provide a level pension from age 60 tieing in with social security benefits at age 65, than would be possible under an individual policy plan.

The actuary's fee on a plan involving 7 eligible employees out of a total of 28 and an annual reserve for past (1/10 of full reserve) and future service of $3,236 (toward which employees contributed $946) was $500 for setting up the plan and $250 for yearly recomputations and filing of the necessary reports with the Internal Revenue Bureau. All of the reserves are invested in United States of America, Series G & K 2½% bonds. The trustees are two employees and a member of the firm, so that there has been no corporate trustee expense. Many banks are not particularly interested in servicing plans with less than 100 lives. One large New York bank's annual fee is based on $5 per capita for holding the policies and paying the premiums where individual policies are used. There is also a charge of ¼ of 1% on the principal of the fund.

A bank is hardly needed when there are less than 25 employees covered under either an individual policy or self-insured plan. If the employer wishes to avoid the responsibility and bother of actuarial computations and investment of funds, the Combination Insured Plan previously explained seems to be the most advisable. An important advantage of this plan over a self-insured plan is that each covered employee has a contract providing many retirement options and guaranteed incomes regardless of the money market and economic conditions at the time of retirement. Insurance companies can do this, since their tables are based on at least 100,000 lives at each age. They have a wider and thus safer spread of investment risks than is the case under a self-insured plan, particularly if stocks or other than government bonds are used.

Another disadvantage of self-insurance, so far as the better informed employees are concerned, is the fact that their pension may be impaired or even discontinued just when the employee or his contingent beneficiary needs it most, if the employing firm has been sold, absorbed or goes out of business 25 or 30 years hence. Pension Trusts which meet with Treasury Department approval must provide that reserves to the credit of employees or pensioners are vested, but it is conceivable that the original purpose of the plan may not be realized in case the employer's business is liquidated or otherwise discontinued.

Many self-insured firms protect their pensioners by using the retiring employee's reserve to buy an insurance company annuity providing a guaranteed income from then on. This may not be as large (unless the over-all earnings of the fund have exceeded 2½%) as the pensions provided in insurance company policies under an insured plan. Example: in 1933 $1,000 would provide a male, age 60, with a life annuity of $92.57. By 1941, this had dropped to $66.13, and today it is $63.13. In fact, $1,000 at 65 only provides $78.33 or substantially less than $1,000 at 60 only 19 years ago.

Profit-Sharing Trusts

Some CPAs prefer Profit-Sharing Trusts to Pension Plans, because the former do not involve such definite annual commitments and are more directly related to earnings. I believe that as the members of the profession become more familiar with the Self-Funded and Combination Pension Plans, explained previously, they will see that Pension Plans can now be safely undertaken without committing clients to more than their business can comfortably afford.

Many personnel and pension experts believe that in employee-relations pensions should take precedence over profit-sharing plans. Every employer who stays in business over a long period of time cannot escape the problem of providing for superannuated employees. A profit-sharing plan is a splendid *final* step in the ideal employee-benefit program as a supplement to a basic pension plan.

Under profit-sharing plans the firm's contributions are not usually and, under Salary Stabilization probably cannot be allocated according to age or length of service if these allocations are proportionately larger for the high salaried employees. This is likely because the older, long-time employees are generally the highest paid. Past service can more effectively be provided for under a pension plan.

Many profit-sharing plans provide for the purchase of annuities *at retirement,* using all or part of the amount to the employee's credit in the fund. This is not as satisfactory to the employees as the assurance of some basic retirement benefit. Because of the uptrend in life expectancy the annuity rates at retirement are likely to be higher than under a formal pension plan, which means a lower-than-expected pension, which would not be desirable if the present inflationary spiral continues.

The usual profit-sharing plan, even where annuities are to be purchased at retirement, does not satisfy most employees' desire for an *assured* pension at retirement. Employees near retirement age at the inception of the plan do not have enough years within which to build up a large enough fund to provide an adequate pension. The younger employees, with less years of service at the start, thus get the best "break".

The best features of both profit-sharing and pension plans may be realized by using part of the firm's annual contributions to provide Ordinary Life policies on each participant in accordance with a pension formula. The balance may then be invested as an *auxiliary* fund. The trustees could pay out of this fund the premiums on the basic policies in years when there were no profit contributions. The higher

(Continued on page 90)

Pension Planning for Small Enterprises

By Abraham J. Briloff, C.P.A.

After briefly outlining certain basic problems incidental to the development of a pension plan for a small organization, i.e., one having fewer than 25 employees, the author discusses an illustrative money-purchase plan which he helped to develop for one of his clients.

At the outset I want to make certain that there is no misunderstanding of my purpose in presenting this paper. Ordinarily, only specialists or experts in their respective fields are asked to furnish you with their experiences in the field of their specialty. I want to make it clear that I am neither an expert nor a specialist in the field of pensions or pension planning. I have been asked to report to you some experiences which I have had in connection with the development of pension plans for certain small business entities, that is, those with fewer than 25 employees. It is my hope, that as a result of the experiences which I shall describe, we shall realize that pension planning may serve as an important means of enriching the services which the general practitioner may render to his clients. Much that has been written and said about pension planning in the past has been directed primarily to the development of pension plans for large enterprise; the complex technical problems of pensions and their related tax problems have had a tendency to discourage and frighten the accountant for smaller units. It will be my objective to try to convince you that there need not be any great mysteries about the development of pension plans for such a small enterprise, and that all that is needed is a general understanding of the subject, so as to indicate to the accountant situations where pension planning might be appropriate. Thereafter, the accountant, with the cooperation of counsel, a trust company or an insurance company will be able to develop an appropriate plan for his client. The Pension Sections of the Bureau of Internal Revenue have been most cooperative in the development of retirement plans; I have found the Bureau to be a valuable source of information, guidance and assistance.

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This article is based on a paper presented by Mr. Briloff at the June, 1952, conference of the Society held at Saranac Inn, N. Y.

Why Have a Pension Plan?

The first question that might confront the practitioner with small clients might very well be: Why have a pension plan for such a unit? We know that in larger entities plans may be required because of provisions in collective bargaining agreements or because the personnel section of the entity decided that a special incentive was necessary and that a retirement plan was the best way of accomplishing this end. Such forces are not generally prevalent in small entities; the motives which would lead to pension plans for such units may be to try to do something for the executives (who frequently are also the stockholders) and for other employees—to permit them to accumulate some kind of reserves, something which

individuals cannot do readily with tax rates at their present levels. Along with the foregoing objective, which might be referred to as the tax objective, are the usual purposes, namely to do something for the employees in order to reduce employee turnover, etc. If this latter objective can be accomplished with small net cost to the entity (again, taxes being what they are) so much the better. Also in our thinking as to the reasons why a pension plan should be considered for small enterprise, looking into the crystal ball (which has turned out to be clouded very frequently) it appears that pensions of some sort will become relatively universal, and that both small and large entities will be required to institute such fringe benefits. It would be far easier to contribute towards this ultimate pension over a longer period of time than a shorter period of time. Therefore, starting a pension plan now, instead of say ten years hence, would make possible contributions over that much longer a period of time, with a resultant reduction in the annual cost.

The Accountant's Role

The question is very frequently asked as to just what role the accountant should play in the development of a retirement plan. It appears to me that the accountant is in an enviable position to recognize the possibilities for pension planning, inasmuch as he is intimately familiar with the entity's financial position, and thereby would be able to determine whether the company can afford a plan. He is also intimately familiar with the corporation's tax position, with the result that he would be able to determine to what extent the government would be contributing towards the retirement plan. In smaller enterprises he is also intimately familiar with the stockholder-executives' tax position and financial condition, and thereby would be able to know whether a retirement plan would be consistent with these executives' plans. The accountant is also able to recognize the extent to which Section 102 is a potential danger and, where this danger exists, pension planning is all the more useful. To generalize, it can be said that wherever the corporation and stockholders are in high tax brackets, it will probably be easy to recognize the desirability of pensions.

The accountant is in an excellent position to aid his clients in the determination of the type of plan which is to be adopted, rather than to leave this question to be answered by experts or specialists who may not always be entirely objective. The accountant, who is generally recognized as being independent, can be more objective in his consideration of the type of plan to be presented. It is to be emphasized at this point (as will be again noted from time to time subsequently), that after having recognized the possibility of a plan, and possibly after having made some preliminary computations and engaged in preliminary discussions with his clients, it is important that the accountant obtain the advice of counsel, inasmuch as a retirement plan does require the drafting of legal documents.

It is also a part of my objective to indicate that these legal documents need not be so complex as to be beyond the comprehension of ordinary mortals, like the accountants for smaller entities.

Basic Concepts of Pension Planning

Turning to the substance of pension planning, there are a number of basic concepts which should be remembered during the course of our discussion. Pensions may be adopted by sole proprietorships, partnerships, or corporations. However, because of the present provisions of the Internal Revenue Code, which do not permit deductions for contributions for the benefit of proprietors or partners, it is probable that most pensions will be developed for corporations, although it is to be emphasized that it need not be so.

There is no limit as to the size of the organization for which a retirement

plan may be adopted. Theoretically, a retirement plan can be developed even if there is a single employee; of course where the single employee is also the sole stockholder, the retirement plan would not be approved by the Bureau unless the retirement benefits to be derived by this employee—stockholder were relatively low, say not in excess of $3,000 a year.

There is also the problem of reasonableness of compensation which must be considered. Thus, where the aggregate of the contribution to the retirement plan, when added to the regular compensation, is an excessive sum, then the Bureau might disallow a portion of the amount sought to be deducted. Where officers' salaries have been a tax problem, it may be necessary to have the pension plan contribution serve to reduce the salary otherwise paid. While in the aggregate this contribution plus the compensation may be equal to the amount previously paid as compensation, there is still an advantage to the employee, because he then derives a 100% present benefit from the contribution, instead of only having available the amount of his compensation *less the tax thereon.* Ultimately, of course, it will bear a tax burden when received.

A qualified retirement plan is one which has been reviewed by the Bureau of Internal Revenue, and where the Bureau has determined that the plan and the trust created by the employer comply with the requirements of Section 165 of the Code. This Section 165 outlines the requirements of the trust arrangement to which the tax deductible contributions may be made; and it also outlines the advantageous tax treatment accorded to the employees who participate in the plan. I will try to avoid any detailed discussion of this section of the Code, as well as of Section 23 (p) of the Code (which allows the deduction to the employer), although from time to time reference to these two sections may be unavoidable. In connection with our discussion of qualified plans, it is important to remember that plans for entities with more than eight employees must also meet the requirements of Wage Stabilization and/or Salary Stabilization, as long as these two controls are with us. Without going into a discussion of these requirements, I believe it fair to say that both wage and salary stabilization regulations, as promulgated to date, *encourage the development of pension plans.*

Available Plans

There are several types of plans which might be adopted for the entities which we are now considering. These plans differ generally as to (1) the type of benefits to be given to the employee and (2) the type of administration for the plan. While there are many different possibilities, involving various combinations of the aforementioned factors, it is my belief that insofar as small enterprise is concerned, the following plans would be most suitable; the employer might agree to make sufficient contributions to the pension trust so as to permit the purchase by the trust of a "level premium" *deferred annuity contract* for each individual employee. In such case the periodic premiums will be sufficient to purchase from an insurance company a fixed life annuity for the employee, starting with the stated retirement age.

A second alternative plan might be referred to as the *deposit administration plan* whereby the insurance company is designated as the trustee, and payments are made to this insurance company as trustee. This company would hold on to the funds, keep a record of the amount of funds which it has received from the employer, indicate the names of the employees for whom the contributions have been made, and would add to the amounts thus contributed a certain interest factor (part of which may be guaranteed at the time of the execution of the trust agreement). Then, upon the retirement of the employee, the insurance company would use the funds thus ac-

cumulated for the individual employee for the purpose of purchasing a life annuity for him. The amounts contributed from year to year, presumably would be sufficient to purchase an annuity of a specified amount, at the time of normal retirement. It is to be noted that under this deposit administration plan, the insurance company is acting somewhat in the capacity of a depository of funds, rather than as an insuror of lives or a vendor of annuities. It would appear that the principal reason for the insurance company's taking on this responsibility is that, by so doing, it obtains a competitive advantage in that it will probably be the company called upon to issue the annuity contract at the time of retirement and, further, there may be some insurance sold currently. I understand that insurance companies are not happy with this type of plan where entities of the size we are considering are involved, because there is not enough of a business incentive for them in such situations.

Another type of plan which I consider useful for small enterprise is the one referred to as the *money-purchase plan*. This is a plan whereby a trust fund is created, to which contributions are made, and from which an employee derives benefits only to the extent of accumulations in this fund to his credit —hence the term money-purchase.

Advantages and Disadvantages of the Money-Purchase Plan

An important disadvantage of the money-purchase plan is that the amount of the benefits payable upon retirement are not determinable or fixed in advance, but instead are based upon the value of the accumulation in the fund for the individual employee. Offsetting this disadvantage, there are many advantages, particularly for smaller enterprise. Thus, a money-purchase plan is more flexible than any plan which requires the introduction of an insurance company. This is so by reason of the fact that a money-purchase plan may remain within the control of the employer (although this control must be fiduciary in nature) to the fullest extent that the employer deems desirable. Thus if the employer so desires, it may, direct (through its Pension Committee) the nature of the investments to be made by the trust; and may, if it so desires, designate members of the Board of Directors to act as trustees. Inasmuch as no contract is required with any insuror, in the event that there is an unavoidable termination of the plan, or in the event that there is to be a reduction in the amount to be contributed to the plan, there would be no loss as a result of the cancellation or amendment of insurance contracts in force. We are all familiar with the loss which is occasioned by any termination of annuity and insurance contracts with an insurance company, because of what is frequently referred to as the loading factor. Along the same general lines, in the event of the termination of employment of an individual employee, there is no loss under this plan resulting from the cancellation or amendment of any contracts, nor is there any burden imposed upon the employee to continue to carry on any existing contracts to avoid loss. (Exactly how the benefits for an employee who has terminated his employment are determined, will be discussed subsequently). Another advantage of the money-purchase plan (as will also be developed subsequently) is that there are no complicated computations required in order to determine the amount of the contributions or the fund values; no actuaries are needed and, as a matter of fact, except for accounting and legal fees incidental to the establishment of the plan, there need be no significant overhead whatsoever attendant upon its adoption or administration.

Another advantage which I have discovered from the use of the money-purchase plan is that each employee is so much more enthusiastic about the plan because he can understand the

basis for the contribution and can see the immediate benefits flowing to him rather than having to look for benefits at the age of 65 (something which younger employees are not readily able to foresee).

Another advantage of the money-purchase plan is that the impact of inflation on the fund may be lessened, to the extent that investment in equities can minimize this impact. This advantage flows from the fact that the trustee may invest in whatever securities it, or the Pension Committee, deems desirable (assuming that the trust agreement authorizes such discretion in investment).

Further, companies which have fixed annuity retirement plans generally find it necessary to bar older workers from participation in the plan, or (what is even worse) refuse to hire older persons because of the pension plan. Where the money-purchase plan is adopted there need be no such restriction, as will be apparent from the illustrative problem to be discussed.

It is because of all of these advantages, centering primarily about complete flexibility, that I have found the money-purchase plan to be the one which is most attractive to small enterprise. It should be noted that life insurance benefits may also be obtained where the money-purchase plan is adopted. If this is desired, the trustees would be authorized to purchase individual life insurance contracts on the lives of the individual employees, thereby reducing the amount of the respective employee's participation in the remaining assets of the trust.

Illustrative Example—Money-Purchase Plan

There is presented (at p. 65) an outline of an illustrative retirement plan of the money-purchase type, based upon one which has been adopted by one of my clients. Most of the provisions of the plan are readily understood and require no extended explanation. Thus, Article I indicates the effective date of the plan and sets up the Pension Committee, which in this particular situation is composed of the corporation's personnel. In connection with the determination of the effective date, it is significant that a tax deduction may be accrued for the taxable year, if the trust has been created on or before the last day of the employer's taxable year, provided further that a small token payment has been made to the trust on or before such last day of the year; *provided also that the remaining payment must be made within sixty days after the close of the taxable year.* It is not necessary that the approval of the Bureau of Internal Revenue be obtained prior to the close of the taxable year.

Article II indicates who the participants in the plan may be. In this particular plan it is provided that only employees over the age of 25 who had served the company more than two years are eligible to participate.

Article III describes the contributions formula. In this particular situation we used a 10% of annual earnings factor. An illustration of the application of this formula follows:

Computations Illustrating the Contributions Formula

Employee (1)	Stock-holder (2)	Salary (3)	Yrs. of Service Prior to 1952 (4)	Current Service Contribution (5)	Total Past Service Fund (6)	Total 1952 Contribution (7)
A	Yes	$30,000.	20	$3,000.	$ 60,000.	$ 9,000.
B	No	20,000.	20	2,000.	40,000.	6,000.
C	No	10,000.	10	1,000.	10,000.	2,000.
D	No	5,000.	5	500.	2,500.	750.
E	No	3,000.	0	Not eligible	—	—
Totals	—	$68,000.	—	$6,500.	$112,500.	$17,750.

See notes to above on following page.

Notes to above:

Column (5) equals 10% of column (3) for each eligible employee.
Column (6) equals 10% of column (3) multiplied by number of years in column (4).
Column (7) equals column (5) plus one-tenth of column (6). (One-tenth of column (6) is used because it was assumed that the past service fund will be contributed over a ten year period).

It is stated in this Article III that none of the contributions, once made, may be revoked by the Company, although Article VIII states that contributions may be made conditional on obtaining the approval of the contribution from the Wage Stabilization Board or the Salary Stabilization Board. This condition is one which is specifically authorized by the Bureau of Internal Revenue. (Note: In this illustrative case approval by the Stabilization authorities is not required inasmuch as there are fewer than nine employees).

Article IV describes the management of the fund, and reference is made therein to a trust agreement which was executed at the time of the adoption of the plan with a trust company as trustee. It is to be emphasized that a trust company need not be introduced as a trustee, but that the trustees may be individuals; I have nevertheless found it desirable to suggest a trust company because it does bring to the plan the element of permanence, with the resultant advantageous effect on the employee. The annual rates charged by the trust company here involved for acting as the trustee in this situation are as follows:

½ of 1% for first $100,000 of average fund value
¼ of 1% for next $900,000 of average fund value
Minimum—$200.

This Article also provides that there shall be a quarterly valuation of the fund for each participant, thereby permitting each participant to know quarterly the value of the fund accumulated for him and thereby fixing the amount of death benefit in the event of death during a quarter.

The value of a participant's interest in the trust (subject to the vesting provisions referred to in Article VI) is determined by adding to the amount contributed for the employee his proportionate share of the income and gains (realized or unrealized) and then deducting therefrom his proportionate share of the losses (realized or unrealized).

Article V authorizes the participant to designate the beneficiary to receive benefits upon his death.

Article VI describes the types of benefits which are available to the participant. Thus it provides that upon retirement at age 65 (provided that the employee has been a participant for at least ten years), the amount in a particular participant's fund may, in the discretion of the Committee, be paid out as a lump sum, or be used to purchase an annuity contract. This Article also provides for the benefits to be paid upon the termination of employment, and sets forth the percentages which are vested at the end of each year's service. Here too, within the discretion of the Pension Committee, the benefits may be paid either as a lump sum, or by the purchase of an annuity. This Article also provides for the death benefits to be paid from the trust.

Article VII refers to the rights and obligations in the event of the termination of the plan. It is to be noted that the plan may be terminated by the Board of Directors of the employer, in its sole discretion, and it is then provided that the entire fund is to be disbursed by the Committee either by direct payment or by the purchase of an annuity, and that again no portion of the funds may revert to the employer.

Article VIII contains various miscellaneous provisions, including a statement to the effect that the employer may not be sued by the employee for any benefits, and that all benefits shall

come from the fund. It also provides that there shall be no encumbrances on the fund by creditors of the employee. It permits amendments to the plan, where the Board of Directors deem such amendments desirable, provided however, that these amendments may not reduce any benefits retroactively. And, as has been indicated previously contributions may be made conditional on obtaining approval from the Wage Stabilization Board or the Salary Stabilization Board, although, for the reasons stated above, such approval is not required in the illustration used above.

* * *

It has been my objective herein to indicate that there need be no complexities, nor mysteries about the development of a pension plan. I hope that my remarks have not made the subject that much more mysterious and that, instead, they have substantiated my belief that pension planning is another way in which the accountant may better serve his clients.

Outline of Illustrative Retirement Plan—Money-Purchase Type

NOTE: This outline is prepared solely for the purposes of this discussion; the actual plan would of course be drawn by counsel.

Article I—General and Administrative Provisions

(a) Effective date

(b) Setting up the Pension Committee consisting of the corporation's personnel.

Article II—Participation in the Plan

(a) Each employee over the age of 25 who has completed more than 2 years service

(b) Excludes temporary, special or part-time employees

(c) Makes provision for employees in armed forces or who have been temporarily laid off.

Article III—Contributions

(a) Provides for contributions of 10% of annual earnings subsequent to the effective date; and

(b) Provides for contributions of 10% of current annual earnings for each year prior to the effective date. This portion may be paid over a ten year period.

(c) Contributions may not be revoked by the Company.

(Note: See illustration above for computations applying this Contribution Formula.)

Article IV—Management of Fund

(a) Refers to the trust agreement executed at the time of the adoption of the plan with a Trust Company as the Trustee designated therein

(b) Provides for a quarterly valuation of the fund for each participant.

Article V—Designation of Beneficiary

(a) Each participant is permitted to designate a beneficiary.

Article VI—Benefits

(a) Provides for benefits on retirement (age 65, provided employee has been a participant for at least 10 years). The amount in the particular

participant's fund may be paid out as a lump sum or used to purchase an annuity contract.

(b) Provides for benefits on termination of employment, based on the vesting portions set forth in the plan, viz: 20% for each full year of service (not in excess of 100%) payment may be made as in (a) above.

(c) Provides for benefits on death, i.e., the full value of employee's account to be paid in full to the designated beneficiary, or to the decedent's estate.

Article VII—Rights and obligations in event of termination of plan

(a) Plan may be terminated by the Board of Directors of employer, in its sole discretion.

(b) Entire fund to be disbursed by the Committee, either by direct payment or by the purchase of an annuity.

Article VIII—Miscellaneous Provisions. Some of these provisions follow:

(a) No recourse to employer

(b) No encumbrances, etc., permitted

(c) Amendments permitted in sole discretion of the Board of Directors, including amendments to comply with I.R.C. 165 (a), provided, however, that no amendment may be made to reduce retroactively the participant's benefits

(d) Contributions may be made conditioned on obtaining approval from W.S.B. or S.S.B.

Auditing Standards and the Extended Procedures— A Re-examination of Some Basic Concepts

(Continued from page 54)

that he has satisfied himself by other means . . . It is obvious that in these circumstances no exception need be taken in the opinion section of the report."[33]

But the "other means" cited, shipping records, contracts, subsequent payment of the account, etc. are merely documents and procedures *normally* examined and undertaken. They represent the conventional and standard internal evidences which must be examined irrespective of the acquisition or non-acquisition of external (i. e., confirmation) evidence. If these are to be the sources of satisfaction by "other methods" under the new rule, then the confirmation procedures need never be undertaken for the typical customers' receivables, for the examination of shipping records, contracts, correspondence, evidences of subsequent payment and more represents only conventional procedure which every auditor is expected to undertake. It is evident that considerable thought must be given to the problem of "other methods" and cooperation will be needed by large and small practitoners in the working up of case studies in this area similar to the *Case Studies In Auditing Procedure.*

These then are some of the basic concepts which, it was felt, required a re-examination. If, in the course of these inquiries, facile solutions to the problems have not been distributed, at least the outlines of the issues are more clearly visible. The light which comes with clearer understanding will point the way to correct and enlightened professional practice. That ready cognizance will be taken of these problems is assured by the integrity which characterizes the profession and by the dynamic character of its development.

[33] *Statement On Auditing Procedure* No. 18, January 1943, p. 128. Also reproduced on p. 28 of the *Codification.*

Current Trends in Accounting

By LEO ROSENBLUM, C.P.A.

Some Capsules Reflecting Modern Practices and Current Problems and Conditions

The Facts of Life

"What It's Like to be a Public Accountant," is the title of an article in the monthly magazine *Changing Times.*[1] These points are covered: what public accounting offers, "what money it commands, how people get started in it, what training is needed, how the life looks from the inside."

From Sleuth to Adviser

What changes have taken place in the accounting profession in the last four decades? "Two world wars and a great economic depression," says C. L. King, F.C.A., a Canadian accountant, "have enhanced the complexity of the business structure and the need for specialization in every field;"[2] the development and expansion in accounting have been phenomenal.

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The concept of the professional accountant's service has changed. Once considered a "seeker-out of fraud and error," he is now looked upon as auditor and professional adviser to business.

Currently, the approach in auditing is more nearly analytical than as recently as two decades ago, in the opinion of Mr. King, who is Secretary and Research Director of the Canadian Institute of Chartered Accountants. Today, emphasis is placed on the fairness of the presentation as a whole, rather than on mathematical accuracy; the principal responsibility of the auditor is to present an informed, independent opinion.

Job Outlook

Job Prospects Are Good: The job outlook is good, says the United States Department of Labor.[3] Both industry and public accounting firms report increasing need for accountants. Cost accountants, particularly, are in demand.

On one side, federal emergency control provisions raise intricate accounting questions; and more men and women are needed to help review the reports and financial statements submitted by businessmen under the new measures. On the other side, more accountants are needed to prepare the reports and statements submitted to the government.

[1] *Changing Times,* Vol. 6, No. 10, October 1952, pp. 21-23.

[2] King, C. L., "The Accountant in Practice: a Canadian Viewpoint" (Paper submitted before the Sixth International Congress on Accounting, London, June 1952), in the *Canadian Chartered Accountant,* Vol. 61, No. 3, September 1952, pp. 112-116.

[3] United States Department of Labor, Bureau of Labor Statistics, in Cooperation with Veterans Administration, "Employment Outlook in Accounting," Occupational Outlook Series, Bulletin No. 1048 (1951), p. 14.

Opportunities for Women: The Department's Occupational Outlook bulletin also notes[4] that female accountants had greater opportunities last year than at any time since the war ended. This stems from the great demand for accountants resulting from the defense program. But not many women are preparing for these openings: of a total of 16,000 accounting majors graduating from college in 1949-1950, only 500 were women.

Junior Accountants Needed: To turn from the government bulletin, employment agencies report that juniors, particularly, are in short supply; large numbers of young men normally available are in the armed forces. Jobs for semi-seniors and seniors are likewise plentiful, though here demand and supply are in better balance.

Whose Statements—Client's or Auditor's?

Statement on Auditing Procedure No. 1, called "Extensions of Auditing Procedure," suggests: "the [independent] auditor should be appointed early in each fiscal year so that he may carry out part of his work during the year."

Four representatives of the independent public accountants for Standard Oil Company (New Jersey) attended the company's annual shareholders meeting last spring.[5] They answered a question concerning the expense accounts during the year.

A shareholder asked the Chairman of the Board of Directors: "Do they [the accountants] not make up the annual [operating] report?"[6] He answered: "They don't set our rules and regulations. They . . . check what we do."

Adventure

Here are some items from the Classified Advertisement section of the *Accountants Journal,*[7] published in London:

"Accountants required by the Government of Sarawak for the Food Control and Supply Department for . . . tour of three years. Salary . . . [;] Cost of living allowance . . . according to number of dependents [;] gratuity of £150 for each year . . . payable on satisfactory completion of service. Outfit allowance . . . [;] Free passages and liberal leave on full salary. . . ."

". . . Assistant (Administration) . . . for service in the Sudan. The duties consist of the setting up of a central storekeeping and accounts system for . . . stores and fixtures. . . . Salary [;] post-service bonus [;] . . . cost of living allowance may also be payable. Outfit allowance . . . There is at present NO INCOME TAX in the Sudan. Free passage on appointment. . . ."

"Accountant for Canary Islands. Complete accounts to balance sheet. Knowledge of Spanish an advantage."

World-wide Gathering

The Sixth International Congress on Accounting, attended by about 2,500 accountants, was held in London in June, 1952. The earlier Congress sessions were held in St. Louis (1904), Amsterdam (1926), New York (1929), London (1933), and Berlin (1938).

These subjects were covered, through papers and discussion, at the 1952 conference: Fluctuating Price Levels in Relation to Accounts, Accounting Requirements for Issues of Capital, The Accountant in Industry, The Accountant in Practice and in Public Service, The Incidence of Taxation.

The Proceedings of the Congress are being printed and will be available shortly. The next International Congress is expected to be held in about five years.

Do We Need a "Mental Aboutface?"

Are accountants incapable of looking forward? Does their preoccupation with the "year ended June 30" render

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[4] *Ibid.,* p. 15.
[5] Standard Oil Company (New Jersey), Report of Annual Meeting, May 28, 1952 (The Company, 1952), p. 23.
[6] *Ibid.,* p. 24.
[7] Vol. XLIV, No. 531, May 1952, p. xv.

them unable to look ahead? These are the questions of Roy Morgan, an Australian opinion researcher[8] who, earlier in his business career, spent 10 years as a public accountant.

Manager of the "Opinion Research Center," Mr. Morgan advises accountants to take more interest in their clients' market research projects; this may involve, he points out, "a mental aboutface." "Only once in my experience," notes the poller, "has a public accountant (or indeed any . . . accountant) come into the picture at the beginning. No one has ever suggested that the company's accountant should be consulted because of his specialized training in handling figures."

Electronics in the Office

Changes Are Coming: What savings can be introduced, what changes anticipated, in office operation? Years ago, points out Ralph W. Fairbanks in the *Harvard Business Review,*[9] plants "dropped literally dozens of manual operations in favor of machines and their demonstrated superiority." Can't this be done in the office, too?

What Electronic Machines Can Do: Electronic machines, reports Mr. Fairbanks, are reliable and largely free from mechanical difficulties; they operate, too, at high speed—the arithmetic element has reached a speed of 10,000 additions a second.

Electronic machines can:

1. Learn what you tell them
2. Apply the instructions when needed
3. Read and remember numbers
4. Add, subtract, multiply, divide, and round off
5. Look up numbers in tables
6. Look at a result, and make a choice
7. Do long chains of these operations one after another
8. Write out an answer
9. Make sure the answer is right
10. Sort or arrange in alphabetic or numeric sequence
11. Know that one problem is finished, and turn to another
12. Determine most of their own instructions
13. Work unattended.

But the Machines Are Still Far Off: "The completely automatic office is still far in the future," reported Professor Howard H. Aiken, director of Harvard University's computation laboratory, at an American Management Association conference recently.[10] The agencies interested in developing automatic computation "have concentrated on . . . scientific computers" rather than machines for business application.

Savings: Although "many obstacles stand in the way of replacement of human [office] workers with electronic machines," other speakers at the A.M.A. conference agreed, electronic office machines have already aided some large companies in speeding up their accounting work. One user[11] reported that financial statements formerly prepared manually required 40 man days; now electronic calculators do the job in 6 to 8 hours.

Are Accountants Good Credit Risks?

The *New York Times* reports:[12] "If one wishes to buy goods on credit it will be . . . easier if one is an accountant or auditor rather than a laborer or farm hand, regardless of income."

[8] Morgan, Roy, "Looking Backward—not Forward," in the *Chartered Accountant in Australia,* Vol. XXIII, No. 1, July 1952, pp. 12-13.

[9] "Electronics in the Modern Office," Vol. XXX, No. 5, Spetember-October 1952, pp. 83-98.

[10] "'Automatic Office' Seen Far in Future," *New York Times,* Financial page, October 17, 1952.

[11] Monsanto Chemical Company.

[12] *Sidelights of the Day* column, Financial page, October 11, 1952, reporting the results of a study by Robert S. Hancock, of the University of Illinois, and others.

While "occupation doesn't determine credit rating," notes the newspaper, "it helps." It appears that "Business executives, accountants and auditors get the best ratings from credit bureaus and department store credit managers." Well down the list of 42 occupations are public officials, who occupy rank 19.

What Is Business Income?

61 widely-known lawyers, economists, accountants, and businessmen studied the question over a period of three years. This "Study Group on Business Income" was sponsored and financed by the Rockefeller Foundation and the American Institute of Accountants.

The Group's report, presented under the title, "Changing Concepts of Business Income,"[13] attracted wide attention, has been reviewed in most accounting magazines.[14]

Commercial

Here is an extract from an accounting machine advertisement in a British accountancy journal:[15]

> " 'The Board of Directors were positively startled,' smiled the Chief Accountant.
>
> "The Chairman looked almost alarmed when I gave him the figures. 'Those are three weeks too soon to be trustworthy,' said he.
>
> "When I convinced him he asked 'Have you suddenly become a genius?'
>
> "It's a possibility to be considered with cautious optimism, I told him, but he knows as well as I do a lot of the headache has gone out of our accounting since we installed the ——— punched card system."

Bouquet

From a British book review: "In this country we are in many ways far behind the U.S.A. in the preparation of explanatory statements to accompany accounts for use in management accounting . . ."[16]

Pellets

Can you answer these questions on current procedures:

1. How does the S.E.C. propose to expand the definition of the word "officer?" Why do accountants object?
2. What does a lawyer expect of his accountant-witness?
3. Do Dutch financial statements recognize inflation?
4. How can the CPAs office avoid duplicate typing of tax return schedules?
5. What follow-up procedure should CPAs employ after clients undergo tax examinations?
6. What problems arise when parent and subsidiary companies' accounts are audited by different public accounting firms?
7. What principles of human relations must be considered in systems work?
8. Did the list of 14 major professions include Accountancy?
9. What are the most useful statements which Accounting can prepare for management?
10. How do the publishers of national magazines account for subscription income received in advance?
11. How can small random samples be used in auditing payrolls?
12. How are C.P.A. examinations graded?

For the answers see:

Journal of Accountancy, October 1952: 1.—p. 402; 2.—p. 434; 3.—p. 448; 6.—p. 468.

New York Certified Public Accountant, July 1952: 4.—p. 438; Sep-

(Continued on page 90)

[13] "Changing Concepts of Business Income—Report of Study Group on Business Income" (New York, The Macmillan Co., 1952).

[14] *See,* among other periodicals, *Accounting Forum,* Vol. XXIII, No. 1, May 1952, pp. 51-52.

[15] *Accountants Journal* (London), Vol. XLIV, No. 535, September 1952, p. vii.

[16] From the review of Parkinson, B.B., "Accountancy Ratios in Theory and Practice," in the *Accountants Journal,* Vol. XLIV, No. 531, May 1952, p. 135.

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Technical Meeting on State Taxes

On October 30, 1952, our Society held a meeting at the Engineering Building devoted to technical and procedural problems in connection with state tax refunds and assessments. The small auditorium was filled to capacity, with quite a number of standees. It was one of the most enthusiastic technical meetings in many years on the subject of State Taxes. Miriam I. Eolis spoke on assessments, and Frederick McCarthy considered the question of refunds under the income and franchise tax laws. A third speaker was Samuel S. Ress, who gave the members an interesting and lively talk on the Unemployment Insurance Tax Law.

As usual, we had the generous cooperation of the State Tax Commission in the presence of Emory W. Burton, Deputy Commissioner, and George W. Klein, Deputy Commissioner. These able administrators answered many questions asked by members from the floor. The meeting was conducted under the auspices of the Committee on State Taxation and Jack Schlosser, the chairman, is to be congratulated for the excellent organization and success of the meeting.

BENJAMIN HARROW, C.P.A., has been a member of our Society since 1928. He is a Professor of Law at St. John's University.

Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is now serving as one of the Vice-Presidents of the Society and is also on the Society's Committee on Federal Taxation, and is past Chairman of its Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation and its Council.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

Non-Resident—Personal Exemption

Two situations have been brought to our attention involving the determination of the personal exemption for a non-resident. In the first case the taxpayer is a non-resident for the entire year. On December 1st, he begins earning income in the State of New York. He is of course taxable on this income, but is he entitled to a full exemption for the calendar year, or only to 1/12 of the exemption?

The return of the non-resident is for a full calendar year, even though the income from New York was earned during one calendar month. The status of the taxpayer as a non-resident did not change during the year. He is therefore entitled to a full exemption for the entire calendar year.

In the second case, the non-resident became a resident of New York on December 1st, when he began to earn income in New York. Does that affect the personal exemption? The statute (Sec. 367-a) provides that where the status of a taxpayer changes two returns must be filed, a non-resident and a resident return. The personal exemption is required to be prorated on the basis of the number of months for each status. That means that the taxpayer would be entitled to one twelfth of the personal exemption on the resident return and eleven-twelfths on the non-

resident return. Apparently the taxpayer increases his tax through the loss of 11/12 of the exemption by becoming a resident at the time he begins earning income in New York State. He can save this tax by waiting one month before he becomes a resident.

Exemption for Dependents

Art. 208 of the income tax regulations has been revised to give effect to a 1952 legislative change in the law with respect to the dependency credits for a head of a family. If he is the head of a family by reason of the existence of one or more dependents for whom he would be entitled to a credit of $400, the credit in respect of one of such dependents is disallowed. A widower who is a head of a family because he maintains a home for two dependent children under 18 years of age will now receive a dependency credit of $400, instead of $800 under prior law. If, in addition to the dependents under 18 years of age, he also maintains a dependent over 18 not mentally or physically defective nor in attendance at a school he would still be entitled to an $800 exemption, since his status as head of a family is not solely by reason of the dependent children under 18 years of age.

Definition of Partnership

Art. 226(a) of the Regulations has been revised to include in the definition of partnership a business being liquidated, "and includes the collection of installment obligations of a partnership whether such obligations arose or resulted from the ordinary operations of the business of the partnership or the sale thereof." This follows a 1952 legislative change in Sec. 350, subd. 11. The broadening of the definition brings a liquidation of a business within the scope of doing business and among other things subjects the business to the unincorporated business tax. In fact, Article 8 of the unincorporated business tax regulations has also been amended to include in the definition of gross income, gains, etc., resulting from the liquidation of the assets of a business or the collection of outstanding installment obligations.

Traveling Expenses—Teachers

Of interest to teachers is a recent ruling[1] by Deputy Commissioner Kassell on the deductibility of traveling expenses incurred by teachers who travel on sabbatical leave. Where a teacher is granted such a leave requiring "travel for specific educational purposes in accordance with an itinerary approved by the Board of Education, is also required to make a detailed report of such travel and receives compensation for the sabbatical leave", the traveling expenses incurred are ordinary and necessary expenses in connection with the production of income and are deductible in computing net taxable income. Commissioner Kassell adds in his ruling that his opinion is in accord with a similar ruling of the Income Tax Unit of the Treasury Department[2]. It should be noted that such deduction would include expenditures for transportation, meals and hotel charges. A sabbatical leave for health reasons is apparently not within the scope of this ruling.

1 October 21, 1952.
2 I.T. 3368, 1940-1 C.B. 29.

Correction—November, 1952, Issue

The article entitled *"How to Hold Your Own—Tax Planning for an Estate"* referred to a 15% limitation on charitable gifts made by individuals (page 671). This was a correct statement in June, 1952, when Mrs. Eolis presented this paper at the Saranac Inn Convention of the Society. Since then, the percentage limitation has been increased to 20% but, unfortunately, the Editor overlooked making the necessary correction in the text.

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

In the December, 1952, issue of this magazine reference was made to a decision of the SEC suspending the accounting firm of Haskins & Sells and one of its partners, Andrew Stewart, from appearing or practicing before the Commission for a period of ten days. At the time that article was written, the text of the SEC's decision was not available, and we printed the SEC's summary of the decision, together with a statement made by Haskins & Sells with respect to the action taken by the Commission.

In the previous issue we stated that when the text of the decision became available, a digest thereof would appear in this column. Because of the importance of the decision in this case, however, and because of the difficulty in condensing the decision, it is reproduced below in full.

We should like to remind our readers that Haskins & Sells will be glad to make available to any interested person a copy of the oral argument of their counsel, the late Hon. Robert P. Patterson, before the SEC which took place on May 8, 1950.

The text of the Accounting Series Release No. 73 follows:

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C.

October 30, 1952

ACCOUNTING SERIES RELEASE NO. 73

Findings and Opinion of the Commission In the Matter of Haskins & Sells and Andrew Stewart, file No. 4-66, (Rules of Practice—Rule II (e)).

PRACTICE AND PROCEDURE

Disqualification of Accountant from Practice Before Commission

Where respondents, a firm of certified public accountants and a partner therein, certified financial statements in a registration statement found by the Commission to be materially inadequate and misleading in that, among other findings, the financial statements grossly overstated intangible assets as a result of the arbitrary use of the par and stated value of shares of stock issued to acquire the assets, including shares expected to be reacquired from promoters as a donation, and attributed to apparently potentially productive items material amounts which should have been shown as promotion services, *held* respondents have engaged in improper professional conduct making it appropriate to deny temporarily their privilege of appearing or practicing before the Commission.

Appearances:

Manuel F. Cohen, for the Office of the Chief Accountant of the Commission.

Robert P. Patterson, Boyle, Feller, Stone & McGivern, and *Saul Levy,* for respondents.

These private proceedings were instituted under Rule II (e) of our Rules of Practice to determine whether the privilege of appearing or practicing before us should be denied,

Louis H. Rappaport, C.P.A., has been a member of the Society since 1933. He is a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A.'s

temporarily or permanently, to Haskins & Sells, a firm of certified public accountants, and Andrew Stewart, a member of that firm.[1]

Hearings were held, and after a recommended decision by the hearing examiner was dispensed with upon respondents' motion, counsel for the Office of the Chief Accountant of the Commission and counsel for the respondents filed briefs and presented oral argument. On the basis of our examination of the record we make the following findings.

The order instituting these proceedings refers to certain accounting services allegedly improperly performed by respondents in connection with the filing by Thomascolor, Incorporated, a Delaware corporation ("Thomascolor") of a registration statement under the Securities Act of 1933 covering 1,000,000 shares of that corporation's Class A stock, $5 par value, to be offered for sale at a price of $10 a share, or a total of $10,000,000. The proceeds of the sale of this stock were to be devoted to an attempt to develop to a point of commercial use various devices, principally in the field of color photography, invented by Richard Thomas, the chief promoter of Thomascolor. Respondent firm, under the supervision of respondent Stewart, performed the auditing work and certified the financial statements of Thomascolor and its predecessors, Thomascolor Corporation, a Nevada corporation ("the Nevada corporation"), Scientific Development Co., a limited partnership ("Scientific"), and Richard Thomas Enterprises, Inc., a California corporation ("Enterprises").

In connection with the Thomascolor registration statement we instituted stop-order proceedings under Section 8 (d) of the Securities Act to determine whether we should issue an order denying effectiveness to that statement. Extensive hearings were held before a hearing examiner, and numerous conferences were held between our Division of Corporation Finance and counsel, accountants, and other representatives of the registrant. After eight amendments had been filed, substantially revising the disclosures made, we dismissed those proceedings and permitted the registration statement as amended to become effective. However, we issued a Findings and Opinion finding that the registration statement as originally filed contained material misrepresentations and omissions with respect, among other things, to the nature and commercial possibilities of the devices and processes proposed to be exploited and the history of Thomascolor and its predecessors, and further finding that the financial statements in the registration statement as originally filed were highly misleading.[2]

The order for hearing in the instant proceeding alleges, generally, that respondents in connection with their work and the issuance of the firm certificate in the Thomascolor registration statement disregarded generally accepted accounting and auditing principles, practices and professional standards and the rules, regulations and long settled decisions of the Commission.

Thomascolor and Its Predecessors

The Nevada Corporation

Thomas, who had been experimenting in the field of color photography, had by 1940 developed a three-color system of photography involving five inventions, of which three were patented and two were covered by patent applications. At that time Thomas was in difficulty with various creditors who had advanced funds to him. After legal actions against Thomas had been instituted by those creditors, it was agreed between them and Thomas that, for their mutual benefit, a corporation should be formed to hold the patents and patent applications. Accordingly, the Nevada corporation was formed with an authorized capital of 1,000 shares of capital stock, no par value, and Thomas assigned the five patents and patent applications to the corporation in exchange for 980 shares of its capital stock. Thomas retained 725 of the shares, assigned 125 shares to an attorney who had rendered legal services, and assigned the remaining 130 shares to eight persons who had advanced funds to him.

Various efforts of the Nevada corporation to finance the further development of the inventions failed. In March 1941 the Nevada corporation issued to Thomas a license for the manufacture and sale of the inventions. Thomas, who was the owner of a substantial amount of equipment, mortgaged it for the purpose of raising funds for the development of the inventions. By 1942 actions had been begun to foreclose some of these mortgages and the earlier creditor actions directed against Thomas were revived. These litigations were settled by an agreement, dated April 22, 1942, between the Nevada corporation, Thomas and the other stockholders of the Nevada corporation pursuant to which Thomas assigned to

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[1] Rule II (e) reads as follows:

"The Commission may disqualify, and deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after hearing in the matter

"(1) not to possess the requisite qualifications to represent others; or

"(2) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct."

[2] *Thomascolor, Incorporated,* Securities Act Release No. 3267 (November 26, 1947).

the Nevada corporation 667½ shares of his stock in the corporation and his interest in the mortgaged equipment. It was also provided that, if Thomas did not repay the creditor stockholders the funds which they had originally advanced to him within 18 months, the assigned shares of stock would be divided among the stockholders other than Thomas. Thomas thereby temporarily lost control of the Nevada corporation.

In January 1944, in order to facilitate the further financing of the Thomas inventions and processes, the Nevada corporation issued a new license agreement, in place of the one originally issued to Thomas. This license designated Edwin C. Street, who had loaned Thomas money and was attempting to work out plans for satisfying the claims of creditors and obtaining funds for the further development of the inventions, as the licensee for the purpose of assigning the license to Enterprises. As noted below, Street subsequently did assign the license to Enterprises. The Nevada corporation also leased and ultimately sold Thomas' equipment in its possession to the latter corporation.

ENTERPRISES

Enterprises was organized in August 1943 with a capitalization of 1,000,000 shares of a par value of $5.00 each. In February 1944, it filed an application with the California Division of Corporations for permission to sell to the public 50,000 shares of $5.00 par value stock, to net the corporation $200,000, after deducting a 20% selling commission to Street and an associate, and to issue 50,000 shares as "promotion shares" to Thomas and Street and to Fleetwood Southcott and Omer Nigh, who were closely associated with Thomas in the promotion activities. The application referred to these four persons as the "promoters of the plan set forth in the application," and stated that the "promotional shares" were to be issued to them "in exchange for the assignment of the license agreement." In connection with the authorization of the filing of this application the Board of Directors of Enterprises fixed the value of the license agreement at $250,000, reserving the rights to "redetermine the value at a higher figure in the event the experience of the corporation with the inventions covered by said license agreement justifies a higher figure."[3]

The California Division of Corporations issued a permit authorizing the proposed issuance and sale of stock. The shares to be received by the four promoters were permitted to be issued "as partial consideration for the transfer first to be made to the applicant of the license agreement herein referred to as recited in said application, subject to the right to receive additional shares as full and final consideration therefor when and as authorized by the Commissioner of Corporations so to do." The permit was issued subject to the assignment of the license agreement to Enterprises and subject to the requirement that the shares to be issued to the four promoters be placed in escrow pending further order of the Division of Corporations and that the holders of such stock agree to waive their right to dividends or to participate in any distribution of assets until the stockholders who had paid cash for their shares should receive as dividends or distributions in liquidation 100% of the amount invested. Thereupon the entire stock issue was disposed of as contemplated, 50,000 shares being sold to the public and 50,000 shares being issued in the names of the four promoters and placed in escrow.

In April 1945 Enterprises filed an application for a permit to sell 274,084 additional shares to the public and to issue 274,084 additional shares to Thomas, Street, Southcott and Nigh. This application was granted only in part, a permit being issued for the sale to the public of an additional 137,000 shares and the issuance to the named individuals of 137,000 shares, these latter to be placed in escrow upon the same conditions as the earlier issue. The additional 137,000 shares were all sold to the public.

The license agreement was stated on the books of Enterprises and included in its balance sheet, which was certified by respondents and filed with this Commission, at $935,000, the aggregate par value of the 187,000 shares of $5.00 par value stocks issued to the four named promoters.

After the second block of stock had been sold, Enterprises purchased the equipment owned by Thomas which it had rented from the Nevada corporation for $149,000, less the amount of rentals theretofore paid. This amount was used by the Nevada corporation to release the equipment from mortgages and other liens, to pay the amounts owing to unsecured creditors of Thomas, and to acquire the stock interests of the creditors in the Nevada corporation. Thomas thereupon reacquired the shares of the Nevada corporation which he had turned over to the Nevada corporation in 1942, and resumed his control of that corporation.

SCIENTIFIC

In June 1945, Thomas organized a limited partnership with the name Scientific Development Co. for the purpose of financing further development of three of his inventions

[3] The same reservation had been noted in connection with a prior application in October 1943, when the value of the license was fixed by the Board of Directors at $225,000. This earlier application was withdrawn following the raising of objections by the California Division of Corporations.

pertaining to aerial photography. Thomas was the sole general partner and received a 65% interest in the partnership in consideration of the transfer of the inventions. The limited partners were Southcott, Nigh and one other, who subsequently assigned their interests to other persons. The partnership received $50,000 in cash for the 35% interest of the limited partners.

THOMASCOLOR

Thomascolor, the Delaware corporation, was organized in February 1946, for the purpose of consolidating the various entities engaged in the development of the Thomas inventions and devices and of obtaining additional funds. Originally its authorized capital consisted of 5,000,000 shares of $5 par value stock, but when it developed that a single class of stock would not insure retention of control by Thomas, the authorized capital was changed to 4,000,000 shares of common stock Class A, $5.00 par value, and 100,000 shares of common stock Class B, without par value, each class having 50% of the voting power regardless of the number of shares outstanding. The holders of the Class A stock were entitled to all dividends paid until they received an aggregate of $1,250,000 after which all dividends were to be paid one-half to the holders of the Class A stock and one-half of the holders of the Class B stock. Upon liquidation, the holders of Class A stock were entitled to receive $5.00 per share before any distribution was made to the holders of Class B stock. Thereafter the Class B stockholders were entitled to receive the amount distributed to the holders of Class A stock, and any remaining assets were to be divided equally between the two classes.

It was determined that Thomascolor would acquire all the assets of the Nevada corporation, Enterprises, and Scientific and also an invention involving television which was owned by Thomas personally. Thomas assigned to Thomascolor all his interest in the invention relating to color television, his holdings of the common stock of Nevada corporation which amounted at the time to 707½ shares, and his interest in Scientific which then amounted to 60%, for a consideration consisting of 56,800 shares of the Class A stock having an aggregate par value of $284,000 and 100,000 shares of Class B stock having a stated value of 10 cents per share, or an aggregate of $10,000. The Board of Directors of Thomascolor, of which the four persons named above were members, fixed the fair market value of these interests acquired from Thomas as at least $294,000. Thomascolor also issued to Thomas 200 shares of Class A stock in consideration of $1,000 paid in cash.

Thomascolor then acquired from Street, Southcott, Nigh and Carl Haverlin, a director of Thomascolor and the Nevada corporation, 90 shares of capital stock of the Nevada corporation, in exchange for 9,000 shares of Thomascolor Class A stock. The Nevada corporation transferred all its assets to Thomascolor in exchange for 100,000 shares of Thomascolor Class A stock which were thereupon distributed pro rata among the stockholders of the Nevada corporation and that corporation was dissolved. In that distribution Thomascolor reacquired 81,377 27/49 shares of its own stock and 18,622 22/49 shares were distributed to the other stockholders of the Nevada corporation.

Thomascolor also acquired the remaining 40% interest in Scientific, which the Thomascolor directors stated had a fair value of $200,000, in exchange for 40,000 shares of Thomascolor Class A stock. Scientific then transferred all its assets to Thomascolor and was dissloved.

Enterprises also transferred all of its assets, except $3,000 in cash, to Thomascolor for 374,000 shares of the Class A stock of Thomascolor. The Board of Directors of Thomascolor found that the fair value of such assets was at least $1,874,000.

THE ALLEGED ACCOUNTING DEFICIENCIES

The accounting treatment to which the order for proceedings refers as the basis for disciplinary action relates primarily to intangible asset items in the balance sheets of Thomascolor and Enterprises.

The Item "Patents and Patent Applications" in the Balance Sheet of Thomascolor

The balance sheet of Thomascolor as originally filed contained the following item:

"Patents and Patent Applications (representing the amounts of such assets as carried on the books of predecessor interests plus the excess of the stated value of common stock issued therefor over the net assets acquired as shown by the books of such predecessor interets)—(Note 2) .... $2,014,941.03"

Note 2 read as follows:

"The amount of $2,014,941.03 at which the item 'Patents and Patent Applications' is carried in the above balance sheet represents the valuation of such patents and

patent applications by the Directors and is based upon the par value of the 579,800 shares of Class A stock of $5 par value less 81,377 27/49 shares returned to treasury and on 10 cents per share for the 100,000 shares Class B issued therefor with adjustments for other assets acquired and liabilities assumed.

"Said valuation does not purport to be the cost to the original owners. The following is a comparison between the amount at which patents and patent applications are carried in the above balance sheet and the amounts at which they were carried in the balance sheets of the predecessor interests:

Thomascolor Incorporated		$2,014,941.03
Predecessor Interests:		
Richard Thomas Enterprises, Inc.:		
License agreement	$935,000.00	
Stock issue expense-commissions	186,991.00	
Undistributed expenses, including depreciation, $70,322.49	215,748.67	
Organization expense	15,653.60	
		1,353,393.27
Scientific Development Co.		173,710.66
Thomascolor Corporation, $39,200.00 less reserve for amortization, $11,625.49		27,574.51
Inventions and processes acquired from Richard Thomas		(Not stated)
		$1,554,678.44

"For accounting purposes it is the intention of the Company to amortize the valuation of these patents and patent applications over the remaining portion of the 17 year period from the date of the basic patent, May 5, 1942, so that the total valuation will be amortized over approximately the next twelve years. The proportion of the valuation, which, representing cost to the original owners, can be treated as a deduction for tax purposes, will not be known until it is established to the satisfaction of the Treasury Department. Accordingly, it should be assumed for the purposes of this Registration Statement that the annual amortization of patents will not be fully deductible for tax purposes."

The order for hearing alleges that this account, which represented all but $536,642.37 of the total assets of $2,551,583.40 shown on the balance sheet, improperly included material amounts without proper accounting evidence of their nature and character as patent and patent application items.

Respondents in setting up the balance sheet of Thomascolor stated the assets at the par or stated value of the stock issued for the purpose of acquiring them. The net assets of the Nevada corporation, Scientific and Enterprises and the television patents were acquired by Thomascolor for 579,800 shares of its Class A stock, $5 par value, and 10,000 shares of its Class B stock, 10 cents stated value. Upon the dissolution of the Nevada corporation Thomascolor reacquired 81,377 27/49 of its own Class A shares, making the net amount issued for those assets 498,422 22/49 Class A shares and 10,000 Class B shares having an aggregate par and stated value of $2,502,112.24. Of this, $30,000 par value of Class A stock was earmarked as having been given to Thomas for the television patents, leaving a balance of $2,472,112.24. For this Thomascolor acquired assets carried on the predecessors' books at $2,044,849.65, of which $1,554,678.44 were intangible items and $490,171.21 were tangible items and deferred charges. The excess of the aggregate net par or stated value of the stock over the book value of the assets acquired, amounting to $427,262.59, was included under patents and patent applications on the books of Thomascolor.

The entering of the assets acquired by Thomascolor at an amount equal to the par or stated value of the stock issued for the purpose of acquiring them was essentially an arbitrary procedure. The Thomascolor shares had not been traded in and there was no standard by which their actual value could be judged. It was impossible to value the intangibles acquired, particularly in view of the long history of failure despite the expenditure of substantial sums Obviously the amount ascribed to patents and patent applications was merely a balancing figure, substantially in excess of the total of the amounts of intangibles in the books of the predecessors, and had no relation to actual values.

In the case of Thomascolor the distortion was intensified by the fact that the stock issued was of two classes having highly unusual characteristics. As has been noted, one-half of

the voting power was lodged in the Class B stock, and it was provided that after $1,250,000 in dividends were paid to the holders of Class A stock, regardless of the number of shares issued, all remaining dividends were to be divided equally between the two classes. Clearly there was no rational basis for placing a value of $5 on each share of Class A stock and stating the cost of assets acquired in exchange for shares of that stock on such basis and at the same time using a value of 10¢ per share for the Class B stock as a measure for valuing assets acquired in exchange for such stock.

Respondents urge that the recording of the assets in an amount equal to the par and stated value of the stock issued for the purpose of acquiring them is an accepted and proper accounting practice where the amount of stock issued is not arbitrarily fixed, but is arrived at on some rational basis. They argue that there are in this case substantial "elements" or "indicia" of arm's-length bargaining sufficient to permit the acceptance of an amount equal to the par and stated value of the stock issued. Respondents' position is in effect that where stock is issued in a series of transactions, some of which are concededly not the result of arm's-length negotiation, a figure based on the aggregate par and stated value of the stock so issued can be sustained in its entirety if part of the transactions contain elements of arm's-length dealing. We cannot accept respondents' view.

In the light of the unsuccessful history of the patents and patent applications, it was clear that their actual value did not approach $2,014,914.03 and respondents should have recognized that the use of that figure might be misleading to investors.[4] And in our opinion the absence of true arm's-length bargaining in important transactions was so apparent that respondents should have recognized the impropriety of using that figure, which as we have noted was $427,262.59 in excess of the aggregate of the amounts at which the intangibles were carried on the books of the predecessors.

The facts indicate an over-all lack of arm's-length bargaining in the transactions fixing the amounts of stock to be issued for the assets of the predecessors. Thomas caused the organization of, and was the dominating factor in, Thomascolor and the three predecessor organizations. He was the president and a director of both Thomascolor and the Nevada corporation and was the sole general partner of Scientific. He had voting control of Thomascolor and the Nevada corporation and, with his associates, had practical control of Enterprises. All action taken by officers, directors and stockholders of Thomascolor and its predecessors was a mere rubber-stamping of Thomas' plans. All the persons having interests in these ventures were dependent upon Thomas personally to develop a successful invention and accordingly their freedom to dispute any course of action he chose was greatly limited. Even if we could accept respondents' contention that substantial elements of arm's-length dealing were involved in various phases of the transactions, these phases were so minor and subordinate that they could not affect the conclusion that the $2,014,914.03 attributed to patents and patent applications was essentially an arbitrary figure.

But we are unable to find that the various transactions involved arm's-length negotiation or bargaining in any substantial sense. In considering these transactions it should be borne in mind that Thomas as the holder of all the Class B stock and only a relatively small amount of Class A stock, which as noted above had limited preferences, had no material interest in limiting the amount of Class A stock to be issued to acquire assets.[5] Thomas thus had little incentive to be other than generous to the other interested persons, and at the same time such persons had no hope of preserving their investment unless there was successful financing.

The first transaction involving the issuance of stock for the purpose of consolidating the predecessors was the acquisition from Thomas in May 1947 of the television patents, 707½ shares of the Nevada corporation and his 60% interest in Scientific in exchange for 56,800 shares of Thomascolor Class A stock and 100,000 shares of Class B stock having an aggregate par and stated value of $294,000. Since Thomas was then the president and sole stockholder of Thomascolor, it is clear that there was no arm's-length dealing in connection with this transaction.

We also cannot find, as contended by respondents, that arm's-length dealings were involved in connection with Thomascolor's acquisition later that month of 90 shares of the Nevada corporation stock from Southcott, Nigh, Haverlin and Street for 9,000 shares of Thomascolor Class A stock. These men had been associated with Thomas in his various

[4] Respondents contend that the figure at which patents and patent applications were carried in the balance sheet of Thomascolor was captioned so as to eliminate any implication that the figure represented the value of the patents. However, as we noted on previous occasions, a dollar and cents figure set opposite an item of property implies it was reached on some rational or precise basis (See *Thomas Bond, Inc.*, 5 S. E. C. 60, 62, 64 (1939)). Moreover, the footnote to this item in the balance sheet expressly describes the figure used as the "valuation" of the patents and patent applications by the directors.

[5] As noted above the Class B stock carried with it 50% of the voting power and a 50% interest in earnings after satisfaction of the limited preferences of the Class A stock. Thomas owned 57,000 shares of Class A stock, which would constitute 4.2% of the stock which it was contemplated would be outstanding in the event that the sale of 1,000,000 shares to the public was consummated.

enterprises for a number of years. They were promoters, officers, directors and stockholders of some or all of the corporations. Respondents urge that this is not a sufficient basis for an assumption that they would accept dictation from Thomas where their own interests were concerned. However, we think the record clearly shows a dispostion to accede to Thomas' various proposals.

The subsequent acquisition of the assets of the Nevada corporation for 100,000 shares of Class A stock of Thomascolor and the dissolution of the Nevada corporation in the course of which Thomascolor received back 81,377 27/49 of such shares and the balance of 18,622 22/49 shares was distributed to the minority stockholders of the Nevada corporation was also not marked by any real arm's-length negotiations. Although in the preceding year the directors of the Nevada corporation approved a proposed sale of its assets to Thomascolor on somewhat different terms, the sale which was actually consummated was not submitted to the directors or stockholders of the Nevada corporation, presumably because Thomascolor then owned more than 80 percent of its stock. The acceptance of the distribution by the minority stockholders without protest did not reflect any independence of action on their part under the circumstances. The Nevada corporation had been attempting to develop its inventions since 1941 without success, and new arrangements and further financing were necessary if its stock was to have any value. In these circumstances the minority stockholders had little choice but to accept the results of a transaction adopted by the management as a possible means of salvaging their investment.

The sale of the assets of Enterprises to Thomascolor for 374,000 shares of Class A stock of Thomascolor was likewise made under circumstances negativing arm's-length bargaining. The directors of Enterprises who approved the offer were Street, S. I. Volz, a friend of Street and William Nigh, a brother of Omer Nigh, an officer and director of Thomascolor and of the Nevada corporation. Neither Volz nor William Nigh appears to have been active in the company's affairs. The directors of Thomascolor who accepted the offer were Thomas, Southcott and Haverlin. While, as respondents emphasize, there is some evidence of differences between Street and Thomas about some matters, in the main they acted in concert in the promotion of Thomascolor and Enterprises.

Nor does the fact that certain of the public stockholders of Enterprises consented to the sale furnish any material element of arm's-length bargaining. Although Enterprises had in April 1946 obtained the consent of a majority of its public stockholders to an offer to sell its assets to Thomascolor, when the offer was actually made, on somewhat different terms, the consent of only 7 public stockholders, owning only 3,250 shares, was obtained, with the balance of the necessary majority being obtained from Thomas, Street, Southcott and Nigh. Moreover, at the time the original consents were obtained, the stockholders of Enterprises were advised that the plans were to finance Thomascolor by the sale of stock at $10 a share and to have that corporation acquire the assets of Enterprises through an exchange of Thomascolor stock for Enterprises stock on a share for share basis. Obviously any arm's-length features of this transaction are minimized in view of the suggestion that was made that a consent would facilitate the transformation of the shares then held by the stockholder into new shares having an offering price of twice the original issue price of the Enterprises shares held, as to which the record indicates the high bid had been $7.50 a share.

While the acquisition of the 40% interest in Scientific, the limited partnership, for 40,000 shares of Thomascolor Class A stock appears to have involved some arm's-length negotiation, there is evidence that some of the assignees of the limited partners were otherwise interested in and connected with other promotions of Richard Thomas. In addition these assignees were, like the minority stockholders of the Nevada corporation and Enterprises, in the position where their funds had been dissipated and they had nothing to lose and no real alternative but to accept Thomas' proposal giving them new interests with the expectation that additional cash could be secured and the possibility of eventual development of the Thomas processes could be kept alive. In any event, this transaction constituted a relatively minor element in the total $2,014,914.03 Patents and Patent Applications figure certified by respondents.

Respondents also seek to justify the carrying of the patents and patent applications at the par value of the stock issued therefor on various other factors. They point to the fact that the purchasers of a 13% interest in the patents later transferred to the Nevada corporation paid $115,625 therefor and urge that this indicates a value of nearly $1,000,000 for the patents. But neither these purchasers nor any other persons were in a position to value the patents on any rational basis. The fact that they were willing to invest in the possibilities of successful development of the patents could be no evidence of their actual value. Respondents similarly urge that the fact that the public was willing to invest $935,000 to acquire half the capital stock of Enterprises is evidence that the purchasers of this stock in effect valued the license agreement, for which, respondents assert, the other half of that stock was issued, at $935,000. However, respondents' argument in this connection does not give sufficient weight to the drastic provisions of the escrow agreement under which the shares

issued to the promoters were made subordinate to the publicly held shares.[6] Respondents also point to the fact that the prices Thomas received for his interests in the predecessors were less than those paid for the minority interest. But these prices were stated in terms of par and stated value of stock and were distorted by the inclusion of the Class B stock at 10 cents per share.

In support of their position on this question, as well as on the other allegations in the order for proceedings, respondents introduced the evidence of three members of other firms of certified public accountants who testified as experts. Respondents lay great emphasis on this testimony and point out that no expert testimony to the contrary was introduced by the Office of the Chief Accountant. However, as we have previously stated, while the opinions of qualified expert accountants may be helpful, this Commission must in the last analysis weigh the value of expert testimony against its own judgment of what is sound accounting practice.[7] We have given careful consideration to the testimony of the experts as well as to all the other evidence in arriving at our conclusions herein. We have not deemed it necessary to discuss their testimony since the views they expressed were substantially the same as those of the respondents.

In summary on the basis of the foregoing we find that the account "Patents and Patent Applications" in the balance sheet of Thomascolor prepared and certified by respondents improperly included material amounts without proper accounting evidence to support those amounts or to justify the certification of the figure stated for that account.

The Inclusion in the Assets of Thomascolor of $698,000 Representing Stock Expected to be Donated by the Promoters

The order for hearing alleges that the balance sheet of Thomascolor, as originally filed, improperly included among the assets the amount of $698,000 representing the par value of 139,600 shares of Class A stock which would be acquired indirectly by donation from Thomas, Southcott and Nigh, subject to the approval of the California Division of Corporations. This amount was included in the $2,014,914.03 figure designated Patents and Patent Applications.

After Thomascolor had acquired the Enterprises assets in exchange for 374,000 shares of its Class A stock, Thomas, Southcott and Nigh entered into an agreement with Thomascolor for the transfer to it, for the nominal consideration of $3, of 139,600 shares of the promotion stock of Enterprises held in escrow, subject to the approval of the California Commissioner.[8] The intent of the agreement was that, upon the dissolution of Enterprises, Thomascolor would acquire and cancel the 139,600 shares of its own Class A stock which would otherwise have been distributed to the promoters. An application was made to the California Commissioner for his consent to the transfer of the shares in escrow. However, when the Commissioner asked for additional information, including a copy of the registration statement filed with this Commission, counsel for the company decided to wait until the registration statement had been amended, and the application was not pursued further and the proposed transaction was never consummated.

This agreement was a part of the over-all plan for the consolidation of the predecessor organizations into Thomascolor. The objective was described by Thomas' counsel as follows: "To obtain satisfactory and propitious financing arrangements it is necessary to effect a consolidated balance sheet for the Delaware Corporation with the lowest possible spread between the value of the patents and the demonstrable costs thereof." Respondent Stewart testified that he "was told that it was all part of the arrangement which was being made whereby Mr. Thomas would not receive more in par value of stock than he claimed to have contributed in cash."

Respondents seek to justify the inclusion of the $698,000 representing the par value of the 139,600 shares of Thomascolor stock in question, in the amount shown for patents and patent applications by pointing to the facts that that stock had actually been issued and was outstanding, that the stock to be acquired for $3 was stock of Enterprises, not stock of Thomascolor, and that the consent of the California Commissioner had to be obtained before that stock and the Thomascolor stock allocable to it could be acquired by Thomascolor. Respondents urge that the Commissioner might have required the retention of the Thomascolor stock in escrow or the distribution thereof to the stockholders of Enterprises who had contributed cash. They also refer to the fact that the dissolution of Enterprises required the vote of a majority of its stockholders.

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[6] Respondents have also argued that in approving the sale of Enterprises stock to the public and the issuance of an equal amount of stock to the promoters, the California Commissioner in effect valued the license agreement at $935,000. However, that there is no basis for this contention is evident from the fact that the stated value of the license agreement was treated as a deduction from capital and not as an asset in the California Commission's correspondence with stockholders, in its second permit, and in its internal reports in connection with the Enterprises financing.

[7] See *Interstate Hosiery Mills, Inc.*, 4 S. E. C. 706, 715 (1939); *Cf. Commonwealth and Southern Corporation*, 9 S. E. C. 609, 616 (1941); *Dayton Power and Light Company*, 8 S. E. C. 950. 974 (1941).

[8] Street, who held the remaining 47,000 promotion shares in escrow, refused to join in this agreement.

Respondents' arguments are without merit. While we recognize that there were conditions precedent to the transactions contemplated by the agreement which might have prevented consummation, and in fact they were not consummated, these contingencies did not justify the accounting treatment adopted with respect to the shares expected to be reacquired pursuant to the donation agreement.[9] Since those shares were issued and outstanding they were properly so shown in the balance sheet. However, it was manifestly improper to measure the cost of assets by the par value of stock subject to an agreement of this nature.

The stock clearly was never intended to be issued in exchange for assets. Its issuance was merely part of the legal mechanics of effecting the consolidation of Enterprises and Thomascolor, and the donation agreement was entered into as a means of reducing the consideration paid by Thomascolor to acquire the assets of Enterprises to an amount net that of the stock expected to be reacquired pursuant to that agreement. Accordingly, the corresponding debit which should have been made in connection with the issuance of that stock should not have been "Patent and Patent Applications" but "Capital Stock Discount."[10]

As we stated in our Findings and Opinion in the stop-order proceedings:

> "The controlling accounting principles are not new. They have been frequently enunciated in our earlier decisions. For example, in *Unity Gold Corporation,* 1 S. E. C. 25 (1934), we specifically stated that donated stock should not be reflected in asset accounts, particularly property accounts, tangible or intangible. This is a well recognized and accepted accounting principle. See also *Yumuri Jute Mills Company,* 2 S. E. C. 81, 87 (1937). The fact that in the instant case approval by the California Corporation Commission is yet to be obtained before the registrant actually receives the 'donated stock' affords no basis for departing from these principles because the nature and purpose of the contract relating to the acquisition of the stock by the registrant establishes it as an item which could not properly be considered an asset."[11]

We conclude that respondents in including in the Patents and Patent Applications account the $698,000 representing the par value of the shares expected to be reacquired pursuant to the donation agreement failed to follow proper accounting principles.

The Item "License Agreement" in the Balance Sheet of Enterprises

The balance sheet of Enterprises as of May 20, 1947, immediately before the transfer of its assets to Thomascolor, showed as an asset the item "License agreement . . . $935,000." This item was qualified by a footnote reading as follows:

> "The outstanding capital stock at May 20, 1947 is 374,000 shares, of which 187,000 shares were issued for cash and 187,000 shares were issued in accordance with the terms of the license agreement whereby the Company acquired the right to use certain specified Thomascolor inventions. No dividends may be paid or other distributions made to the holders of promotion stock until the shareholders who paid cash for their shares have received either as dividends or as other distributions of the Company's assets, in cash or its equivalent, amounts equal to $5.00 per share. Of the 187,000 shares of stock sold for cash, all but nine shares were sold by the Company's fiscal agent, who received as commission the amount of $1.00 per share, or a total of $186,991."

The order for hearing alleges that this item improperly included promotion items. Respondents acknowledge that it is a well established accounting principle that where stock

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[9] Respondents have asserted that at the time their audit was made there was serious doubt by all concerned whether the shares covered by the donation agreement would ever be reacquired. It may be noted, however, that this position is inconsistent with others advanced by respondents in arguing that the figures they used for the patents and patent applications and the license agreement accounts were justified. Respondents' argument noted previously that the public investment of $935,000 in Enterprises imputed a comparable value for the shares issued to the promoters is based on the contention that the restrictions placed on the escrowed stock were only temporary, whereas in connection with the donation agreement they stress the possibility that these restrictions would be retained indefinitely. In addition, respondents contend that, even apart from asserted arm's-length features of the various transactions, there were other indications that the amount at which the patent account was stated was reasonable. If such amount were valid, as contended, there should have been no serious doubts as to obtaining the necessary approval of the California Commissioner in order to effectuate the donation agreement. Such doubts could only be based on concern as to the value of the patents and of the Thomascolor stock to be distributed to the public stockholders of Enterprises. If respondents had considered these matters they should have been aware of the conflict between a determination as to the reasonableness of the adopted values, on the one hand, and the giving of weight to doubts as to the California Commissioner's approval of the donation agreement, on the other hand.

[10] The impropriety of the treatment followed by respondents is evident from the fact that under it upon actual reacquisition and cancellation of its stock it would have been necessary to reduce Thomascolor's property accounts. Had the treatment we suggest been followed no such deflation of the property accounts would be necessary since they would not have been inflated in the first instance and the required entries . . . would simply be to eliminate the capital stock discount (and the corresponding capital in the stock accounts). On the other hand, even were the stock not reacquired, the discount would remain and would properly continue to be shown as such for the reason that the framers of the transactions recognized that no value was received for the stock.

[11] *Thomascolor Incorporated,* Securities Act Release No. 3267 (November 26, 1947), p. 18.

is issued for promotion services, the consideration received therefor should be shown in the balance sheet as promotion services and should not be included in property or similar accounts.[12] However, respondents seek to justify their treatment on the ground that promotional services were not involved and that the evidence which was available to respondents in connection with their audit so indicated.

In our opinion the record shows that the 187,000 shares of the stock of Enterprises issued to Thomas, Street, Southcott and Nigh were issued at least in large part in consideration for promotion services. These four men had been engaged in various efforts looking toward the development of the Thomascolor inventions and a program of financing over a long period of time and the applications to the California Division of Corporations described them as "promoters." The first license agreement, which was issued to Thomas in 1941, cost Thomas nothing and he was unable to develop any value for it. The second license agreement, which was issued to Street, cost Street nothing. This agreement provided that it was issued to Street solely for the purpose of his assigning it to Enterprises and that the agreement would become void if this were not done. Under these cricumstances it should have been apparent to respondents that it was highly improbable that the stock issued to the above persons was issued solely in consideration of the license agreement.

The Office of the Chief Accountant urges that respondents were put on notice that promotional services were included in the consideration for the stock because of the use of the term "promotion stock" by counsel and by the California Division of Corporations in granting its permit to issue the stock. Respondents, on the other hand, argue that "promotion stock" does not necessarily mean stock issued for promotional services but may mean stock issued for property, tangible or intangible, in connection with the formation of a company, and urge that they were justified in regarding that designation as consistent with the issuance of the stock for property because they found other evidence to that effect.

Respondents place considerable reliance on the fact that the permits granted to Enterprises by the California Division of Corporations authorized the issuance to Street, Thomas, Southcott and Nigh of stock "as partial consideration for the transfer first to be made to the applicant of the license agreement herein referred to as recited in said application." Respondents point to the fact that the license agreement is mentioned as a sole consideration for the issuance of such stock and that nowhere in the permit is there any use of the words "promotion services." Respondents argue that this, as well as two intra-office memoranda of the California Division of Corporations which recited the license agreement as the consideration for the stock, shows that that Division understood the applications for permits to mean that the license agreement was the sole consideration for the stock and did not think that promotion services were in any way involved. Respondents assert that they were entitled to put great weight on the finding of the California Commissioner of Corporations, as a disinterested public official charged with the duty of protecting investors, that the stock was issued for the license agreement. They emphasize that the permit was required to be made a part of the subscription forms submitted to investors.

Respondents also stress that at the time they undertook the engagement they were informed by either Thomas or his counsel that the license agreement was the consideration for the shares, that the corporate minutes and records stated that the license agreement was the consideration, that neither Thomas, Street nor any of the various counsel for Thomascolor with whom respondents had extensive contacts throughout the period of their audit ever indicated that there was any consideration other than such agreement or raised any question with respect to the item under discussion, that drafts of financial statements were submitted to counsel and others and no comment was made, and that the narrative portion of the draft of registration statement which had been prepared by counsel and approved by the Board of Directors of Thomascolor described the assignment of the license agreement as being in consideration of the issuance of the stock in question.

We cannot agree wtih respondents' position that the evidence that no promotional services were involved was so clear that they were justified in accepting it as a fact without further inquiry. It was evident that the stock in question had been issued in connection with the promotion of the company, particularly in view of the facts that it had been treated as "promotional shares" by the California Division of Corporations and had been referred to as "promotion stock" by various persons associated with the enterprise. In such circumstances

[12] We have on many occasions criticized the inclusion in property and other accounts of the par value of shares issued to promoters for services. See *Haddam Distillers Corporation*, 1 S. E. C. 37 (1934); *Yumuri Jute Mills Company*, 2 S. E. C. 81, 86 (1937); *National Boston Montana Mines Corporation*, 2 S. E. C. 226, 250 (1937); *Rickard Ramore Gold Mines, Ltd.*, 2 S. E. C. 377, 389, 390 (1937); *Paper Sales Company of Detroit, Inc.*, 2 S. E. C. 748, 754 (1937); *Platoro Gold Mines, Inc.*, 3 S. E. C. 872, 881 (1938); *Thomas Bond, Inc.*, 5 S. E. C. 60 (1939); *MacDonald Mines Limited* (N. P. L.), 7 S. E. C. 223 (1940); *Resources Corporation International*, 7 S. E. C. 689, 736 (1940); *Poulin Mining Company Limited*, 8 S. E. C. 116, 621 (1940); *Automatic Telephone Dialer, Inc.*, 10 S. E. C. 698, 706 (1941); *F. G. Masquelette & Co.*, Accounting Series Release No. 68 (July 5, 1949). *Cf. Continental Distillers & Importers Corp.*, 1 S. E. C. 54, 77 (1935); *Brandy-Wine Brewing Company*, 1 S. E. C. 123 (1935); *Snow Point Mining Co., Inc.*, 1 S. E. C. 311, 315-6 (1936).

and in the light of the many cases in which problems had arisen with respect to the description of promotional items,[13] there was an affirmative duty on respondents as accountants practicing before this Commission to make certain that the stock was not issued for promotion services. In our opinion respondents unjustifiably placed too much weight on the language of the permit as indicating that the license was the sole consideration for the issuance of the stock. Adequate inquiry into the background of the issuance of the permit was not made. The record shows that representatives of the San Francisco office of the respondent firm visited the office of the California Division of Corporations for the purpose of obtaining information about other subjects and could have very easily inquired about the background of the issuance of the permit. Donald A. Pearce, Assistant Commissioner of Corporations of California who testified in these proceedings pointed out that the permits referred to, and were qualified by, the applications, and that the applications referred to the shares issued as promotional shares and to the four individuals named above as promoters. Pearce stated that Street had told him and he had always understood that the shares had been issued for promotional services and would have so advised the respondents if they had asked him.

The failure of counsel and others to mention the subject of promotion services voluntarily was not sufficient excuse for not making a complete inquiry. Respondents' duty went further and required at least that they ask direct questions as to the existence of promotion services instead of relying on the silence of those persons on that matter or on general statements or recitals that the license agreement was the consideration for the stock. From the evidence in the record, it is clear that the four promoters and counsel, as well as Pearce, understood that the stock had been issued for promotional services. The four promoters had entered into a written agreement for the division of the promotional stock among them which recited as the reason for such division "the services and contributions made by them for the benefit of this promotion." If respondents had made proper inquiry into the reasons why shares of promotional stock were issued to four promoters for an ostensible consideration of the assignment of a license agreement by only one of them, such inquiry should have led them to this agreement which on its face disclosed that the consideration for the assignment of the license agreement included promotional services rendered for the benefit of Enterprises.[14]

A memorandum prepared by Thomas' counsel in January 1947, and furnished to respondents summarizing the situation and outlining a proposed course of procedure, which was a document evidently prepared with considerable care, stated that the 187,000 shares were issued to Thomas and his associates, "either in consideration of the assignment of the patent license agreement between the Nevada Corporation and Street, or as promotional stock," and "apparently in payment of organization and promotion." The respondents assert that this memorandum was "preliminary" and was prepared when counsel did not have full information, particularly copies of the permits issued by the California Division of Corporations. In any event, however, it afforded a further reason for a full inquiry by respondents to ascertain whether promotional services were in fact involved.

On the basis of our examination of the record we find that respondents failed to follow proper accounting principles and practices in their treatment of the item "License Agreement" in the Enterprises balance sheet certified by them.[15]

Footnote Explanations

The order instituting these proceedings alleges that the footnote explanations to the balance sheets in the registration statement as originally filed were inadequate because of failure to provide and to present properly important factual data.

It is alleged that the footnotes are inadequate in failing to disclose the status in liquidation of the two classes of Thomascolor stock. At the time the registration statement was filed, Thomascolor had outstanding approximately 500,000 shares of Class A and 100,000 shares of Class B common stock which had been issued to acquire the assets of its predecessors. The charter then provided a preference in liquidation for the Class A stock to the extent of $5 per share, after which the Class B stock as a class would receive an amount equal to the aggregate paid to the Class A shareholders, with any amount remaining being divided equally by the two classes. Under the registration statement, 1,000,000 shares of Class A stock were to be sold to the public for $10 per share. As a result of the substantial

[13] See cases cited in note 12, *supra*.

[14] We cannot accept respondents' argument that the services referred to in the agreement were personal services rendered to Thomas and not to Enterprises. This interpretation is inconsistent with both the language of the agreement and the evidence in the record that Street's efforts were directed toward effecting a financing of the Thomas enterprises.

[15] The designation of "License Agreement, $935,000" was also made in the footnote to the item Patents and Patent Applications in the Thomascolor balance sheet, and respondents were similarly deficient with respect to it. Having found a lack of arm's-length dealing in the acquisition of Enterprises' assets by Thomascolor we cannot accept respondents' contention that, whatever its nature in the balance sheet of Enterprises, this item lost its identity upon the acquisition of that corporation's assets by Thomascolor and was properly attributable to the latter's Patents and Patent Applications account.

discrepancy between the sale price and the liquidation preference, as much as $5,000,000 of the $10,000,000 to be paid by the public purchasers of Class A stock might be distributed in the event of liquidation to the holders of the previously issued Class A stock and to Thomas as the holder of the Class B stock. The significance of this situation is highlighted when consideration is also given to the dividend privileges of the two classes of stock. It appears that the excess to be paid by the public purchasers of the Class A stock over its par value of $5 per share would be credited to paid-in surplus and such surplus could under Delaware law be distributed as dividends. However, under the charter, the Class A stockholders had a preference to receive, as a class, only the first $1,250,000 of dividends declared and paid by Thomascolor, after which the Class A stockholders would be entitled to only one-half of all future dividends, the other half being payable to the Class B stock.

Respondents cite Rule 3-18 (d) (3)[16] of our Accounting Regulation S-X, which requires disclosure in the financial statements of the extent to which the liquidating value of preference stock is other than its par or stated value and the effect thereof on surplus, and contend that the rule implies that no disclosure was necessary in this case since the par and liquidating values of the Class A stock were the same at the time the financial statements were originally filed. However, the principal reason for this rule is to require a presentation which will reflect fully and adequately the equities of the various classes of stockholders and to indicate the status of surplus particularly from a dividend standpoint. Respondents should have recognized that it is equally important to reflect in the financial statements the extent to which the amount paid or to be paid by preference stockholders exceeds the liquidating value of their shares and the extent to which such excess would be available to others than those preferred stockholders. Such disclosure was necessary in order that the financial statements should not be misleading,[17] and failure to make this disclosure constituted a material omission. Although, as respondents point out, the liquidation preferences are set out in the narrative part of the prospectus, we do not regard this as sufficient reason for failure to describe them in the financial statements.

It is also alleged that the footnotes are inadequate in failing to set forth complete data as to Thomas' ownership and voting power of shares of Class A stock and of all the Class B stock. Respondents urge that such disclosure was not called for because of the evidence that they relied on as showing that the transactions as between Thomas and public investors were at arm's length. However, as shown above, respondents were not justified in resting their accounting presentation on the so-called elements of arm's-length bargaining in this case, and the nondisclosure in the financial statements of the identity of Thomas as the controlling person, of both registrant and of the persons or corporations from whom the registrant acquired property, resulted in making those financial statements materially deficient and misleading.[18]

The order for proceedings further alleges that the footnotes were inadequate in failing to present the complete facts as to the possible reacquisition by Thomascolor of 139,600 shares of its Class A common stock. As we have stated above this transaction was not properly reflected on the balance sheet. While the impropriety of including the par value of such shares in the item Patents and Patent Applications would not have been cured merely by additional footnote disclosure, the footnote explaining the situation was in any event inadequate. It merely stated that Thomascolor had entered into an agreement for the acquisition for a nominal consideration of 139,600 shares of the promotion stock of Enterprises subject to the approval of the California Commissioner. The footnote should have also stated that if such approval were obtained and the restrictions on these shares were removed, Thomascolor, upon the liquidation of Enterprises, would acquire 139,600 shares of its own Class A stock, and that Thomascolor had agreed to cancel such reacquired shares. In addition, the footnote should have stated the effect such transaction would have on the accounts, and should have identified the parties to the agreement as certain of the promoters of Thomascolor.

We cannot agree with respondents' contention that good accounting practice did not require it to supply detailed matter of this nature and that it properly did not do so because such detail would have unduly called attention to the possible benefits from reacquisition of the stock and have created an impression that such reacquisition was assured. Full disclosure of transactions between management and the registrant is required in the financial statements whether the facts disclosed might be interpreted as favorable or unfavorable,[19] and a

[16] This rule has since been renumbered Rule 3-19 (d) (3). Accounting Series Release No. 70 (1950).

[17] See Rule 3-06 of Regulation S-X.

[18] We have repeatedly held that where property of a corporation is stated in its balance sheet at an amount determined in a transaction in which the transferor was a person in control of the corporation, such facts must be disclosed in the balance sheet. *Continental Distillers & Importers Corp.*, 1 S. E. C. 54, 78 (1935); *Rickard Ramore Gold Mines, Ltd.*, 2 S. E. C. 377, 389-90 (1937); *Platoro Gold Mines, Inc.*, 3 S. E. C. 872, 880-1 (1938); *Thomas Bond, Inc.*, 5 S. E. C. 60, 64 (1939); *MacDonald Mines, Ltd.* (*N. P. L.*), 7 S. E. C. 223, 226-7 (1940); *Automatic Telephone Dialer, Inc.*, 10 S. E. C. 698, 706-7 (1941).

[19] *Cf.* Accounting Release No. 37 (November 7, 1942); *Red Bank Oil Co.*, Securities Act Release No. 3110 (January 4, 1948), pp. 8, 15, 16.

carefully worded explanatory footnote would preclude misinterpretation. Particularly, if respondents had followed the proper accounting procedure we have outlined above, namely, showing a smaller patent account and a stock discount item in the amount of the par value of the shares involved, presentation of the details of the transaction would not be subject to any misleading inferences.

It is also alleged that the footnote explanations to the various balance sheets certified by respondents were inadequate in failing to present complete data as to alleged known costs and the extent of alleged unknown costs to affiliated transferors of property to Thomascolor and its predecessors whose balance sheets were certified by the respondents. Respondents attempt to distinguish the precedents relied on by the Office of the Chief Accountant in support of this charge[20] on the ground that they involve cases where there was an absence of arm's-length dealing and where the lack of adequate disclosure was with respect to figures included in the financial statements, whereas in the instant case, respondents assert, the transactions in question were not lacking in arm's length and not arbitrary and the costs of Thomas and the other allegedly affiliated transferors were not required to be set forth and did not appear in the financial statements or anywhere else in the registration statement as originally filed. They contend that for those reasons it was not incumbent upon them to refer to such costs or to the inability to verify certain of them.

We cannot, however, as our previous discussion demonstrates, accept respondents' contention that there were sufficient elements of arm's-length in the transactions by which Thomascolor or its predecessors acquired interests or property from Thomas and the other promoters or by which Thomascolor acquired the remaining interests in its predecessors that the stated consideration could be viewed as not having been arbitrarily determined. Accordingly, apart from the impropriety of respondents' accounting treatment to which we have already referred, respondents should in any event have disclosed the costs of affiliated transferors in these transactions and their inability to determine or verify them, where such was the case.[21] We find that their failure to do so, particularly in view of the promotional nature of the situation being dealt with, constituted a disregard of the accounting requirements under the circumstances.

For the above reasons we conclude that the footnote explanations were inadequate in the respects set forth.[22]

Rulings on Exceptions

During the course of the proceedings exceptions were taken to rulings of the hearing examiner overruling objections to certain questions and admitting and excluding various exhibits. In general, the question involved in these rulings is whether proffered material was available to respondents at the time of their audit. We have carefully examined the evidence involved and the rulings of the hearing examiner and conclude that the exceptions should be overruled.

Conclusion

As has been shown, respondents' accounting treatment and disclosures were materially inadequate and the financial statements certified by them were materially misleading in important respects. Those deficiencies resulted directly from respondents' failure to follow

(Continued on page 87)

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[20] *Platoro Gold Mines, Inc.*, 3 S. E. C. 872 (1938); *Breeze Corporations, Inc.*, 3 S. E. C. 709 (1938); *Petersen Engine Co., Inc.*, 2 S. E. C. 893 (1937). *Cf.* Accounting Series Release No. 13 (1940); Accounting Series Release No. 37 (1942).

[21] In the financial statements as subsequently amended, the notes to the Thomascolor and Enterprises balance sheets were amended to indicate that the cost to Thomas of $149,000 of equipment purchased from him by Enterprises was not susceptible of verification. A note was also added to the Thomascolor balance sheet indicating that of the 40% minority interest in Scientific acquired by Thomascolor for 40,000 shares of $5 par value Class A common stock the cost to those holding 29½% was $42,000 and the cost to those holding the remaining 10½%, which was shown on the partnership records at $15,000, was unknown to the company. This information and similar information with respect to Thomas' other alleged costs, the costs if any incurred by the promoters in obtaining the license agreement for Enteprises and the alleged costs in connection with the development of patents held by Nevada should have been furnished in the financial statements as originally filed. While we permitted the registration statement to become effective without insisting on so full a presentation, the registrant was advised at that time that the financial statements, as amended, were not entirely satisfactory, and we did not regard the remaining inadequacy as to this item as sufficiently material to keep the statement from becoming effective.

[22] Respondents have contended that in view of the disclosures which they made in the financial statements with respect to the Patents and Patent Applications item their accounting treatment should be accepted under our Accounting Release No. 4 (April 25, 1938). That release provides, in part: "In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant *and the position of the Commission has not previously been expressed in rules, regulations or other official releases of the Commission,* including the published opinions of its Chief Accountant." (underscoring ours). We have noted in our discussion of the patent item and the extent of the footnote disclosure required in connection with it that Commission precedents have expressed disapproval of the type of accounting treatment and disclosure adopted by the respondents. In view of those precedents, Accounting Release No. 4 cannot aid respondents in this case.

Payroll Tax Notes

Conducted by SAMUEL S. RESS

Unemployment Insurance—Employer Held Not Liable for Section 575.4 Penalty

The Appeal Board held that the Industrial Commissioner had erred in assessing eighty-five $10 penalties against the employer for not filing the wage information reports on forms L.O. 12 within 7 days after demand. The employer, a building contractor, normally employed 1,200 persons. In December, 1951, it had been compelled to lay off about 80 per cent of its employees.

Beginning with January, 1952, the Employer was required to issue withholding tax information to all of its employees and also to file income tax returns, social security and unemployment insurance returns. Prior to June 4, 1951, the Employer had been required by the regulations of the Industrial Commissioner to supply wage information covering all of its employees, quarter-annually. The Employer's record system had been geared to the demands of the federal and state requirements then in effect.

Effective June 4, 1951, in compliance with changes in the law, the Industrial Commissioner amended his regulations requiring employers to file reports by limiting the quarterly reports to contributions due and payable and dispensing with the necessity of filing wage information covering individual employees for each quarter. Under the law and the Industrial Commissioner's Regulation 23, wage information is required of the employers to be supplied within the seven-day period after demand.

Nothing had occurred from between June 4 and December, 1951, to indicate that the Employer's record system was deficient in any respect because of changes in the Unemployment Insurance Law and Records Regulations of the Industrial Commissioner. After the mass lay-off in the Employer's establishment towards the end of December, 1951, large numbers of its employees filed claims for benefits commencing with January, 1952. As a result of these filings of claims hundreds of demands were served by the Industrial Commissioner on the Employer requesting wage information in each individual case.

These demands were superimposed on all other reports which the Employer was required to file in January, 1952, and the necessity for the issuance of Withholding Tax statements to all of its employees resulted in a complete break-down of the Employer's record-keeping system. As a result, the Employer was unable to comply with 85 of the several hundreds of demands that were made on it to supply wage information in those cases.

The Industrial Commissioner thereupon issued determinations imposing penalty assessments against the Employer of $10, each, for his failure to supply the wage information within the

SAMUEL S. RESS has been an Associate Member of our Society since 1936, and is also a member of the Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is a member of the Society's Committees on Clothing Manufacturing Accounting, on Labor and Management, and on State Taxation.

7-day period covering 85 claimants, under the provision of Section 575.4 of the law.

The Employer contested the determinations and the penalty assessments and requested a hearing before a Referee. The Referee sustained the determinations and the assessments against the Employer, who then appealed to the Unemployment Insurance Appeal Board.

The Appeal Board held that the issue was whether or not the failure of the Employer to supply the information was due to circumstances beyond his control. They held that the Employer's method of keeping records had been adequate to meet all requirements of law prior to June 4, 1951, and that after that date until December, 1951, nothing had occurred which could lead the Employer to believe that its method of recordkeeping was inadequate.

They held that it was their opinion that the Employer, on the basis of its prior experience, could not have foreseen the unusual combination of events occurring at a single time and thus preventing it from supplying the required wage information. Under such unusual circumstances, the Employer's failure to supply the wage information in the case of 85 individual claimants was due to circumstances beyond its control and therefore the penalty assessment should not have been imposed. (Unemployment Insurance Appeal Board Case #33, 349-52; 536-509-52R decided December 12, 1952).

Accounting at the S.E.C.

(Continued from page 85)

generally accepted accounting and auditing principles and practices and professional standards, and rules, regulations and prior decisions of this Commission. Under the circumstances we find that respondents have engaged in improper professional conduct within the meaning of Rule II(e).

Respondents' disregard of their professional obligations is inexcusable. It was clear from the material examined by them that attempts had been made over a long period of time to develop and exploit the inventions covered by the patents and large sums of money had been expended without any evidence of commercial success. Under the registration statement the public was to be asked to invest $10,000,000 more in this highly speculative venture. It was against this background that respondents prepared and certified balance sheets which grossly overstated intangible assets by the arbitrary use of the par and stated value of shares of stock issued to acquire the assets, including shares expected to be reacquired from promoters as a donation, and attributed to apparently potentially productive items material amounts which should have been shown as promotion services.

Respondents have steadfastly maintained that their presentation and procedures were reasonable and justified. They insist that they acted in good faith, that the situation presented was a unique one and if we find any error on their part it would reflect no more than a difference of judgment as to method of handling such situation, and that no willful or deliberate disregard of our rules or accepted accounting practice was involved. It is also stressed that Stewart enjoys an excellent reputation in his profession and has never had any prior question raised with respect to his accounting activities.

We accept respondents' assertion that they acted in good faith and accordingly do not find any willfulness in the sense referred to by them. However, in a disciplinary action under Rule II(e) we are not required to make such a finding. We are of the opinion that respondents' accounting work in connection with the Thomascolor registration statement was so deficient in the respects set forth above, as a result of their failure to give this professional undertaking the degree of care and inquiry it demanded under the circumstances, that disciplinary action is required.

After careful consideration of all pertinent factors, including those stressed by respondents, we have reached the conclusion that respondents Haskins & Sells and Andrew Stewart should be denied the privilege of practicing before this Commission for a period of 10 days beginning 30 days from the date of the issuance of our order.

An appropriate order will issue.

By the Commission (Chairman Cook and Commissioners McEntire and Rowen), Commissioners Adams and Rossbach not participating.

ORVAL L. DUBOIS, *Secretary*.

Office and Staff Management

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Office Managers' Meeting Notes

At the November luncheon meeting a number of interesting subjects were discussed, among which were the following:

Auto Insurance on Staff Mens' Cars

Where accountants use their cars in the firm's behalf, as in traveling from client to client, or where otherwise authorized to do so, directly or by implied approval of the practice, the adequacy of the insurance protection should be investigated. Firms should cover themselves against possible claims arising from damage or injury to, or by, their employees. Personal injury coverage of $100,000/$300,000 is considered a minimum.

Investigation of Applicants for Position of Senior Accountant

One large firm follows the practice of having the police record of all applicants for the position of senior accountant investigated as soon as their employment is decided upon. They feel that the confidences imposed in employees of that rank require the greatest care in selection. Several undesirables, including a few convicted of commercial frauds, were so discovered.

MAX BLOCK, C.P.A. (N.Y., Pa.) is a director of the New York State Society of Certified Public Accountants and has been the Chairman of the Society's Committee on Administration of Accountants' Practice. He is a member of the firm of Anchin, Block & Anchin.

A private investigation agency is used for this purpose.

Learning How to Read Rapidly

Accountants who must read inordinately large volumes of accounting, tax, and other material will find that their capacity can be considerably expanded by a course in rapid reading. One member reported a very satisfactory increase in his own reading coverage as a result of such a course. The total time required by the course is 20 hours, and it is given by a number of schools in New York City.

Handwritten Tax Returns

A partner of a rather large firm reported that they have decided to handwrite their tax returns and have them mechanically reproduced. Apparently they are confident that clients will not object to a handwritten copy.

There is one school in New York City that gives a course in hand printing. This may be useful for employees who will do considerable handwriting of tax returns.

Photographic Reproduction of Tax Returns

The Commissioner of Internal Revenue has finally indicated that photographic copies of the following forms, on approved paper, will be accepted:

1040, 1120, 1120 D, 1120 EP

Form 1120 must be reproduced on blue paper. This covers the largest number, by far, of the tax returns prepared.

The following returns will be accepted by both the Commissioner and

the New York State Tax Commission on translucent master copies:

1040 ES, 1041, 1065, 201, 205

This means that the original, and not the photographic copy will be accepted by the tax departments. In this event, the photographic copies can serve as file copies for the accountant and the taxpayer.

Form 1040 C must, as yet, be submitted on the government's form.

It is known that several firms are, and others are planning to prepare handwritten copies of tax returns and submit reproduced copies, or the originals, to the tax departments and clients. This will speed up the completion of tax returns materially, reduce overtime and strain, and bring about a substantial economy where the volume of returns is large.

Accountants' Files

In last month's column the subject of space wasters was discussed. The logical arrangement of files is also a subject of great interest and with diverse views as to what is the best system. Here is a plan which has been found to be very practical by a progressive accounting firm dealing with medium-sized clients essentially.

Division of Files:

A. Business Clients

   1. Current File—containing in separate folders:
      - a) current working papers of interim audits
      - b) prior year's working papers and reports
      - c) permanent file
      - d) current tax file (5 years' returns)
      - e) tax correspondence file
      - f) typed copies of all annual reports
   2. Transfer Files
      - a) prior years' work papers and reports, including permanent file data no longer required
      - b) prior years' tax files, including tax correspondence no longer required

B. Individual Income Tax Clients

   1. Current tax files (5 years' returns), including life-time gift tax file
   2. Prior years' tax files

The current files of business clients are, in effect, a series of individual folders kept in the order indicated. On the first folder there is a raised name plate, which device makes it unnecessary to use a separate name or divider tab. Only open folders are used in this section, thereby facilitating the removal or insertion of papers.

Comments of other accountants as to improvements in the foregoing arrangement will be welcome. Other aspects of the filing system will be discussed in future issues.

Important Accounting Partnership Tax Decision

A most important decision has been handed down by the Tax Court in an action which represented a consolidation of three cases (*Carol F. Hall,* 19 TC, No. 57). The question dealt with was the moot subject of the tax treatment of payments by an accounting firm to retired partners and to the estates of deceased partners. In the subject case the Tax Court held that the payments were not taxable to the remaining partners and as a consequence were ordinary income, and not capital gains, to the beneficiaries.

The Court made the following significant point in winding up its decision:

"We think that the partners in entering into the 1936 agreement, intended that a retired partner, or the estate of a deceased partner, should share in the profits of the firm, as profits, for a limited period after the event, that the provision was in the nature of a mutual insurance plan in which each partner assumed its possible burdens in consideration of the assumption of a like obligation by his partners to him, and that the payments here in controversy were properly deducted by the continuing partners in de-

termining the distributable partnership income taxable to them."

This is a most important decision (though not the last word) for those accounting firms who disavow goodwill in the payments to retiring partners and estates of deceased partners. It perhaps is an even more important decision than the famous *Coates* case because the partnership provisions cited in the decision are of a more prevalent type than in the *Coates* agreement.

The quoted provisions regarding retirement and death benefits may well serve as a model for firms who desire to achieve a similar end. Even the use of the Court's words, "mutual insurance plan", may be used as a further aid in reaching this objective.

Methods of Funding Pension Plans Involving Less Than 50 Lives

(Continued from page 58)

contributions in good years would cover any such advances as well as the actuarial reserves needed to provide the funds necessary to convert the Ordinary Life policies to annuities at retirement. Any excess of each employee's share of the profits and earnings of the trust (possible under a self-administered auxiliary fund partly invested in equities) could be drawn by or paid to him, as under any of the standard profit-sharing plans, and thus provide some extra cash during the adjustment period following retirement.

Current Trends in Accounting

(Continued from page 70)

tember 1952: 5.—p. 573; October 1952: 7.—p. 603; 8.—p. 624.

Accounting Review, July 1952: 9.—p. 287; 10.—325.; October 1952: 11.—p. 472; 12.—p. 523.

Breaking with Convention

In 1946, the American Pulley Company adopted a method of "cyclical accounting." The company "saves for a rainy day" by setting aside liquid reserves in prosperous times, and "stabilizes its expenditures on the downswing." In periods when sales are cyclically high, operations are charged and reserves are credited; when the downturns are reached, the reserves are charged with appropriate expenses. To see how this has worked, read the *Harvard Business Review* article, "Funds for Stability," by Joseph L. Snider.[17]

[17] Vol. XXX, No. 4, July-August 1952, pp. 86-96.

The Excess Profits Tax Exchange

Conducted by David Zack, C.P.A.

This department is a clearing house for questions, problems, comments and rulings regarding Excess Profits Taxes. We are especially interested in special and informal Bureau rulings on Excess Profits Taxes. All items of general interest will be published herein and full credit will be given all contributors unless they request otherwise. All inquiries and contributions should be addressed to:

Editor, The Excess Profits Tax Exchange
The New York Certified Public Accountant
677 Fifth Avenue
New York 22, N. Y.

Personal Service Corporations

Corporations which can qualify as personal service corporations may elect to avoid the payment of excess profits taxes (IRC Sec. 449). This election must be made annually, on the form 1120, by means of the filing of a Schedule PS. However, there are many subjective factors in the determination of qualification of a personal service corporation and later events may serve to destroy apparent current qualification in that category. It would therefore seem advisable to file a protective EP schedule with the return even when the taxpayer elects to be taxed as a personal service corporation. This should be done in order to protect the taxpayer against the claim of an incomplete return in the event that the corporation ultimately fails to qualify as a personal service corporation. No excess profits tax need be computed on the EP schedule in this case and a rider should make it clear that the taxpayer is making its election to be taxed as a personal service corporation and that the EP schedule is being filed solely for protective purposes. However, certain other elections have to be made on the EP form in the event that the corporation finally is determined to be subject to excess profits taxes—such as the election to use the historical invested capital method. It would seem wise, therefore, to indicate such a choice on the EP schedule at the initial filing.

Of course, corporations which qualified as personal service corporations must pay the regular corporate normal tax and surtax, and the stockholders are taxed on the undistributed Supplement S net income essentially like an ordinary dividend. It would therefore seem advisable, at first blush, to liquidate the corporation, operate as a partnership, and save the corporate normal tax and surtax. This would again involve a capital gains tax, possibly mitigated by Section 112 (b) (7), and presumably offer the advantages of a family partnership with the refinements previously discussed.

David Zack, C.P.A. and member of the Bar, is a member of our Society and of its Committee on Federal Taxation. He is Chairman of the Committee on Municipal and Local Taxation.

Mr. Zack is a Lecturer on Taxation at The City College (N.Y.) School of Business and Civic Administration and at the New York University Institute on Federal Taxation.

Mr. Zack has written on tax matters for various publications. He is a partner in the firm of David Berdon & Co., Certified Public Accountants.

However, there are often cogent reasons for the continuation of the corporate vehicle, despite the normal tax and surtax costs. Thus, the personal service category may be elected annually, so that in certain years it may be advantageous not to make the election. On the other hand, in a partnership, the individual partners must always report their distributive share of the partnership earnings. There may be net operating loss carryforwards available to the corporation which would be lost on dissolution, or a cushion of prior years' earnings against which future losses may be carried back. In this connection it should be noted that net operating loss carrybacks and carryforwards are not distributed to stockholders with undistributed Supplement S net income but are given effect in the computation of corporate net income. It should also be remembered that the Revenue Act of 1951 extended the period of carryover of certain net operating losses.

There are many situations where a corporation may inadvertently fail to qualify technically as a personal service corporation despite apparent equitable qualification. The law restricts corporate, inactive or retired stockholders to the ownership of 30% or less of the outstanding stock. Thus "at all times during the taxable year", the stockholders who control 70% of the stock must be engaged in the active conduct of the business. Transfers of stock within this 70% group between active stockholders is permitted but the incapacity, retirement, death or other disqualification of an active stockholder during the taxable year which breaks this 70% rule, arbitrarily denies the corporation qualification as a personal service corporation.

A major problem in the determination of whether a corporation qualified as a personal service corporation is the distinction between income resulting from personal services as against earnings arising from the risk or use of capital. The courts seem to feel that even when there are substantial personal services, the income may not be ascribed primarily to the activities of the shareholders so as to permit qualification if the income is ascribable to other factors such as special sources of business, valuable contracts, subagents, or a prominent name.

Trading corporations may not qualify as personal service corporations. Fifty per cent or more of the gross income of a corporation may not consist of gains, profits or income derived from trading as a principal. However this test is negative only, the mere fact that a corporation's trading profits is less than 50% does not necessarily qualify it under this criterion. The 50% test is merely a conclusive presumption against qualification, even if that hurdle is jumped, the burden still rests on the taxpayer to prove that capital is not a material income producing factor.

The stockholders of a qualified personal service corporation must regularly devote substantial time and energy to the affairs of the taxpayer. This requirement would seem to make it impossible for two or more qualified personal service corporations to be owned by the same group of stockholders.

A personal service corporation is not permitted to trade as a principal in the service of others. This raises the problem of distinguishing between the sale of employees' professional or skilled services—which would serve to disqualify the taxpayer—and the use of mere ministerial and incidental services —which presumably would not interfere with the personal service classification.

If a corporation is engaged in two or more activities, and capital is a material income producing factor in one phase of the business, or if some aspect of the enterprise is otherwise disqualified from personal service qualification, it would seem wise to consider separate corporations. This would normally correlate with other tax planning considerations and special

consideration should be given to provisions of the Revenue Act of 1951.

Supplement S net income is the starting point for the computation of the tax on the stockholders of a personal service corporation. This figure is computed by subtracting the regular corporate normal tax and surtax from the corporate net income and a special limitation is set for contributions. Contributions may be deducted, to the extent paid, up to a maximum of 15% of the Supplement S net income. The special accrual of contributions permitted to corporations in the regular income tax computation is not available in this computation.

Net operating loss carrybacks and carryforwards are applied in the computation of the corporate net income which is the base for the Supplement S net income. The stockholders of a personal service company therefore do not pick up their proportionate share of these losses in the manner of partners in a partnership.

The computation of Supplement S income represents the only occasion in the income tax law in which no annualization of net income is required for a short taxable year resulting from a change of accounting period. Since no tax is computed on this income, annualization would, of course, be superfluous.

The "undistributed Supplement S net income" is the Supplement S net income reduced by the amount of dividends paid during the taxable year. This income is taxed to the stockholders on the last day of the taxable year as if it had been distributed to them. Section 115 of the Internal Revenue Code is fully applicable and the current year's earnings is usually ample to cover the hypothetical distribution. In any event, the surplus account should be carefully analyzed, especially in view of the fact that the provisions regarding Personal Service corporations were in effect during World War I and World War II, and accumulations of earnings during those years may very well not be taxable on current distribution, since they were previously taxed to shareholders and are now treated as contributions to capital.

Where a corporation has several classes of stock outstanding, particular attention should be paid to the dividend rights of the different categories in the determination of the taxable income of each shareholder.

The fact that the undistributed Supplement S net income is allocated on the basis of stockholdings on the last day of the taxable year permits a retroactive dispersal of income to a taxpayer's spouse and/or minor children by gift or sale.

Inasmuch as it may be many years before final qualification as a personal service corporation is determined, it would seem wise to file protective claims for refund for all stockholders who include undistributed Supplement S income in their tax returns. In the event that a taxpayer neglects to include his share of undistributed Supplement S net income in his return, the Treasury Department has a special seven year statute of limitations. A foreign stockholder of a personal service corporation is deemed to receive a dividend from sources within the United States and withholding is required.

CORRESPONDENCE

To the Editor of *The New York Certified Public Accountant*:

Our federal tax structure is destroying our incentives to do business, and with it our national economy is being put in jeopardy. In addition to state and local taxes, the federal corporate tax rates rise rapidly from 30% to 82%, and the individual rates soar from 22% to 88%. Long before these maximum rates are reached, human initiative is dampened because of anticipated increased tax burdens on profits, and inadequate offsetting tax cuts on business losses.

When business initiative is frustrated, our national economic life suffers and with it democracy is challenged. A country afflicted with economic, political and social distress is rife for the spread of communism. Encouraged human initiative is the crux of our way of life. We must not curtail it. We are already in the simultaneous throes of national deflation and inflation. The steel and other defense industries are still prospering, while the textile and leather industries among others are undergoing a recession. It is to be regretted that the national defense program stemming from the Korean Incident is making it possible for our country to sustain what is left of our national prosperity. It would seem to some, therefore, that only an accelerated defense program necessitated by a full-dress World War III would restore our full measure of national prosperity. Businessmen in the currently depressed industries attribute their plight to overproduction, under-consumption, or specifically the dearth of defense orders. Economists are prophesying a recession in the year 1953 or 1954. This is a dismal future to anticipate.

Taxation is the price we pay for our civilization. That explains why the Eskimo's tax burden is relatively lower than ours. This fact by no means condones extravagance in government spending, or excuses excessive government intervention or control over our economic lives.

But high tax rates in themselves do not assure the government of the necessary revenue to perpetuate our culture. Unless citizens are willing to take business risks and to make profits, the tax yield will not reach expectations. Little wonder that our excess profits tax law is a disappointment to the Treasury.

Tax laws do more than raise government revenue. They can destroy some industries, and can also encourage others. The size of the tax on oleomargarine as compared with that on butter decides whether the oleomargarine industry will flourish. Depletion tax deductions in the oil and mineral industries are primarily intended to encourage oil drilling and mining. Consequently, our government revenue from these sources fluctuates proportionately with the incentive of our citizens to engage in these industries. It is to be deprecated, therefore, that our democracy in action is a government of a majority of minorities in which the latter all too frequently are motivated by selfish economic interests, or are just ignorant of our national welfare.

We do not want a war or an accelerated defense program with all its waste of lives, time and wealth to perpetuate our prosperity. We do not want to revert to severe price, wage and salary controls, to pump-priming with government projects, or to government subsidies and loans. We can put our own businesses in order if the government would restore to us our business incentives for which our country is famous. The annual revenue loss

that our government will sustain because of the expiration in 1953 and 1954 of the excise, excess profits, corporate income and individual income levies will be $\$8\frac{1}{2}$ billion. New Tax legislation will have to be enacted to restore all or part of this revenue depending upon the amount of national economizing that can be effected.

In the planning for new tax legislation, *let the government consider offering all taxpayers a tax rate cut if their annual earnings exceed their moving average earnings of their last four years.* The suggestion is simple of application, and does little violence to our present tax structure. Our country and the Treasury alike are bound to prosper thereby. And let other tax proposals eliminate discrimination and relieve unjust burdens in taxation.

Very truly yours,

J. H. Landman

New York, N. Y.

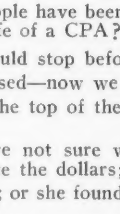
AN ADIRONDACK VIEW

Big Moments in the lives of people have been the subjects for paintings by artists. What are the big moments in the life of a CPA?

1. Birth—without which we could stop before we start.
2. Automobile driver's test passed—now we can do things and go places.
3. Senior in High School—at the top of the teen-agers, sophisticated and full of knowledge.
4. College graduation—we were not sure we could make the grades; and pop wasn't sure he could make the dollars; but we started, stuck, and did.
5. Marriage—we found the girl; or she found us, we will never know. (Vice versa for our women CPAs).
6. CPA at last—all spelled out in full, on a script printed certificate, with a gold seal no less.
7. It's a ———; be it boy or girl, we become a Proud Parent. (Now, rollicking music that gets jazzy then quiet, to denote the passing of twenty-odd years.)
8. Then the First Grandchild—the biggest moment of them all! We know; his name is Gwynne Leonard Spencer, he is seven months old. What a boy! What a Merry Christmas!

We hope you had the same. And it looks as tho CPAs are about like other folks—well, not too different!

Leonard Houghton
"Adirondack Chapter."



BOOK REVIEWS

(Continued from page 10)

The book consists of 104 pages, 8½ x 11 inches in size, of which the first 70 comprise text, tables and two useful checklists. The balance is an appendix of forms developed by the author for estate planning which are reproduced with the permission of The Mutual Benefit Life Insurance Company, Newark, N. J., for which Mr. Gordon is Director of Advanced Underwriting Services. The forms consist of schedules for marshalling estate assets and objectives and of worksheets for estate planning. The reader will find them most useful for his own analyses.

The book does not purport to supply answers to the many questions which may arise in connection with a particular state of facts. By way of conclusion the author says:

> "One other thing that ought to be stressed is that the day of the lone wolf is over. We are living in too complex a society for any one man, no matter how brilliant, to be able to run all the affairs of his estate without expert guidance. That doesn't mean that an estate owner must not make his own decisions. No one else can make them for him. But he is a blazing fool if, before he jumps at a conclusion, he does not consult competent legal authority, competent insurance authorities, and competent tax and investment counsel. He simply cannot afford to take a chance on ignorance—the cost is much, much too high."

This is sound advice.

Leonard Price

New York, N. Y.

Credit Management Year Book 1952-1953 (Volume 19)

Compiled by A. Leonidas Trotta. Credit Management Division, National Retail Dry Goods Association, New York, N. Y., 1952. Pages: 333; $6.00 to NRDGA members; $10.00 to non-members.

True to tradition, the 19th volume of the Credit Management Year Book (which Mr. A. Leonidas Trotta—manager and research director of the Credit Management Division of the N.R.D.G.A. has just compiled) is timely, full of information, and vital to the credit executive and accountant. It covers such a variety of subjects that the reviewer wonders how he can, year after year, continue to put together so important a group of articles by top flight credit executives, on so many varied subjects, all dealing with consumer credit. Inasmuch as he has done it again—"Hats off to A. L. Trotta."

The year of 1952-53 shows a change in problems confronting the credit executive. Release of credit controls of all kinds; no letup in home building; agreement by all economists that there will be no recession in business but that we can look forward to continued good business for this period; change in consumer thinking after election; the higher cost of operations; branch store expansion; and the increased desire of retailers for more credit business—are a few of the things we have to think about.

The current edition does not give us an answer to all these problems but, in its many subjects covered, we can see how some of them are being met and solved in other stores. This volume will enable you to keep pace with the very latest developments and will put you in a position to be among the best informed by providing you with a wealth of original, practical and time-saving ideas.

Of special interest to credit executives and accountants should be the section devoted to research and operating statistics. Now, by comparison with other stores, we can measure the operating efficiency of our credit departments and show cost as a percentage of net credit sales, dollar costs per transaction, and dollar costs per account billed. This study covers all classifications of stores from those under half a million dollars to those doing over 20 million dollars. A great deal of time and effort has gone into compiling these data, but with the ever-increasing cost of doing business it can be timely and educational.

Considerable space is allotted to the current controversy between credit executives and accountants on the subject of the pros and cons of new cycle billing control techniques, with emphasis on one vs. two or more control plans.

A complete Bad Debt Loss Survey classified by credit volume and providing loss ratios for charge, installment and revolving credit accounts is another feature of the current issue. This will prove valuable as it offers a gauge of loss for various types of accounts to be used as a basis for comparison with the retailer's current operation. Now we can see how good or bad we are.

A verbatim report on various discussions and conclusions arrived at by groups of credit specialists at the annual conference, is also published. All phases of credit management are covered.

The ever-present problems of credit sales promotion—collections—credit management—authorization—identification—branch stores and bureau relations, are again covered and many modern and up-to-date ideas are presented.

The current issue of the Credit Management Year Book is a must for the desk of all credit executives and accountants serving retail stores.

Albert S. Kleckner

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